S. Hrg. 101-1045

SECOND ROUNDTABLE HEARING ON THE SAFETY AND SOUNDNESS OF FANNIE MAE AND FREDDIE MAC

HEARING

BEFORE THE

SUBCOMMITTEE ON
HOUSING AND URBAN AFFAIRS

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

ON

THE SAFETY AND SOUNDNESS OF THE FEDERAL NATIONAL MORTGAGE ASSOCIATION [FANNIE MAE] AND THE FEDERAL HOME LOAN MORTGAGE CORPORATION [FREDDIE MAC]

AUGUST 2, 1990

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE
33-340 WASHINGTON : 1990

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

5241-25

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

DONALD W. RIEGLE, Jr., Michigan, *Chairman*

ALAN CRANSTON, California
PAUL S. SARBANES, Maryland
CHRISTOPHER J. DODD, Connecticut
ALAN J. DIXON, Illinois
JIM SASSER, Tennessee
TERRY SANFORD, North Carolina
RICHARD C. SHELBY, Alabama
BOB GRAHAM, Florida
TIMOTHY E. WIRTH, Colorado
JOHN F. KERRY, Massachusetts
RICHARD H. BRYAN, Nevada

JAKE GARN, Utah
JOHN HEINZ, Pennsylvania
ALFONSE M. D'AMATO, New York
PHIL GRAMM, Texas
CHRISTOPHER S. BOND, Missouri
CONNIE MACK, Florida
WILLIAM V. ROTH, Jr., Delaware
NANCY LANDON KASSEBAUM, Kansas
LARRY PRESSLER, South Dakota

Steven B. Harris, *Staff Director and Chief Counsel*
W. Lamar Smith, *Republican Staff Director and Economist*

Subcommittee on Housing and Urban Affairs

ALAN CRANSTON, California, *Chairman*

PAUL S. SARBANES, Maryland
CHRISTOPHER J. DODD, Connecticut
JIM SASSER, Tennessee
JOHN F. KERRY, Massachusetts
RICHARD H. BRYAN, Nevada

ALFONSE M. D'AMATO, New York
CONNIE MACK, Florida
NANCY LANDON KASSEBAUM, Kansas
LARRY PRESSLER, South Dakota
PHIL GRAMM, Texas

W. Donald Campbell, *Staff Director*
Bruce Katz, *Senior Counsel*
Lawrence H. Parks, *Counsel*
Grace Morgan, *Republican Staff Director*

CONTENTS

THURSDAY, AUGUST 2, 1990

Page
Opening statement of Senator Cranston 1
  Prepared statement of Senator Cranston 4
Opening remarks of Senator Dodd 13
Opening remarks of Senator D'Amato 40

WITNESSES

Alfred DelliBovi, Under Secretary, Department of Housing and Urban Development, Washington, DC 13
  Prepared statement 15
  Response to written questions of Senator Dodd 202
John C. Weicher, Assistant Secretary for Policy, Development and Research, Department of Housing and Urban Development, Washington, DC 22
  Prepared statement 24
Michael Basham, Deputy Assistant Secretary for Federal Finance, Department of the Treasury, Washington, DC 41
  Prepared statement 68
Thomas Gillis, managing director, Standard and Poor's Corp., New York, NY.. 42
  Prepared statement 80
  Response to written questions of Senator Dodd 203
Bill Oliva, managing director, Solomon Brothers, New York, NY........ 48
W.H. Hal Hinkle, chairman, Mortgage-Backed Securities Executive Committee, Public Securities Association, New York, NY 40
  Prepared statement 86
Leland Brendsel, Chairman and Chief Executive Officer, Federal Home Loan Mortgage Corporation [Freddie Mac], Washington, DC........ 32
Caryl S. Bernstein, Executive Vice President, General Counsel and Secretary, Federal National Mortgage Association [Fannie Mae], Washington, DC........ 32
  Prepared statement 93
Allan Hunt, executive director, Vermont Housing Finance Agency, Burlington, VT 36
  Prepared statement 102
John J. Kriz, vice president, Moody's Investors Service, New York, NY 51
Peter J. Blampied, president and chief executive officer, Boston Five Cent Savings Bank, Boston, MA 52
  Prepared statement 113
Robert Edelstein, co-chair, Center for Real Estate and Urban Economics, University of California at Berkeley, CA 36
  Prepared statement 127
Eldad Coppens, James D. Wolfensohn, Inc., New York, NY 34
  Prepared statement 135
Thomas H. Stanton, counsel, Olwine, Connely & Chase, Washington, DC 31
Bart Harvey, deputy chairman, The Enterprise Foundation, Columbia, MD........ 35
  Prepared statement 153
David F. Seiders, Ph.D., Chief Economist and Senior Staff Vice President for Mortgage Finance and Housing Policy, National Association of Home Builders, Washington, DC 33
  Prepared statement 161
Carole Berger, senior vice president, C.J. Lawrence, Morgan Grenfell Inc., New York, NY 37
  Prepared statement 173

Page
Cushing Dolbeare, chairperson, National Low Income Housing Coalition, Interim Executive Director, National Coalition for the Homeless, Washington, DC.......... 34
Prepared statement.......... 178

ADDITIONAL MATERIALS SUPPLIED FOR THE RECORD

Congressional Budget Office, letter dated July 20, 1989, to John Kriz, Moody's Investors Service.......... 185
National Association of Realtors, statement for the record.......... 192
Fannie Mae, report by David O. Maxwell, chairman and CEO.......... 204
Mortgage Bankers Association of America, statement submitted for the record.......... 217
Responses to questions posed by the Congressional Budget Office to Moody's Investors Service.......... 187

SECOND ROUNDTABLE HEARING ON THE SAFETY AND SOUNDNESS OF FANNIE MAE AND FREDDIE MAC

THURSDAY, AUGUST 2, 1990

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Subcommittee on Housing and Urban Affairs,
Washington, DC.

The subcommittee met at 2:42 p.m., in room SD–538 of the Dirksen Senate Office Building, Senator Alan Cranston, presiding.

Present: Senators Cranston, Dodd, and D'Amato.

OPENING STATEMENT OF SENATOR CRANSTON

Senator Cranston. Our hearing in the roundtable will come to order.

I thank all of you for your presence and those of you at the table for your participation in this discussion.

This is the second in a series of oversight sessions on the long-term financial soundness of the Government-sponsored mortgage finance corporations, Fannie Mae and Freddie Mac.

I have a somewhat longer detailed prepared statement that I will submit for the record, and I will briefly touch upon a few of the points at this stage.

These two corporations in recent years have taken on enormous importance to the nation's home mortgage finance system, the home mortgages in every part of the country. Together they support 60 to 70 percent of the country's conventional mortgage market.

Last year alone they financed two million home mortgages. That has been particularly important at a time when the Federal Government generally and HUD through the 8 years of the Reagan administration, backed away from doing very much about housing in our country.

Fannie Mae and Freddie Mac provide benefits to virtually every community in the country. They reduce monthly mortgage payments for millions of Americans and their families by greatly increasing the efficiency of the home mortgage market.

Alan Greenspan appeared before the full committee recently and testified to the important public service provided by Fannie Mae and Freddie Mac, another element to the secondary mortgage market.

We are close to achieving our goal through this committee's work of strengthening the effort in our country to develop affordable housing. We passed a housing measure recently by an overwhelming Senate vote, only one vote cast against the bill. The House passed its own version of the housing measure yesterday by an overwhelming vote. We'll be in conference soon to develop those measures into a final form.

We have much to make up for these lost years. Anti-housing idealogues in the Reagan administration repeatedly tried to weaken Fannie Mae and Freddie Mac. Bipartisan efforts in Congress blocked all that.

Now we have to make sure, as part of our challenge, that Fannie Mae and Freddie Mac and other elements of the secondary mortgage market receive appropriate oversight, both by Congress and the executive branch. We have to consider whether they are faithfully carrying out their public mission as determined by Congress. We have to have procedures in place to make sure that the activities of Government-sponsored mortgage finance corporations primarily benefit American homeowners and families.

Just as important, we have to make sure that they are financially sound. We cannot get into any situation where these companies cannot carry out their public purpose and we cannot expose taxpayers to unnecessary risks. We've made clear our determination in Congress to strengthen oversight of Fannie Mae and Freddie Mac.

My objective is to make sure that HUD develops the capacity in HUD to carry out the sophisticated and effective oversight of Fannie Mae and Freddie Mac that the secondary mortgage market requires. I believe a good start has already been made, but progress must not be slowed or weakened by lack of attention at the top or by routine bureaucratic obstacles.

An important focus of today's hearing is to check on HUD's progress in implementing its oversight responsibility. We also need to assess some of the specific suggestions for oversight of Fannie Mae and Freddie Mac that have been floated in recent months. Some of these suggestions sound very good. Others, I think, are problematic.

I strongly doubt that it would be good public policy to give any one regulatory bureaucracy the power to control and interfere with Federal housing policy and foreign policy and education policy and other policy areas that can be most effectively be carried out through a Government-sponsored enterprise. As it is, the Federal Government has enough difficulties in carrying out effective solutions to pressing national problems.

Each of our witnesses has had an opportunity to review the OMB Treasury proposals. I invite your assessment of the details as well as of the package as a whole.

This afternoon, chairing, as you see, will be conducted in a roundtable format. Participation in earlier round table sessions that we've conducted have found that this format permits a more open and useful discussion of ideas among witnesses and subcommittee members with give and take, back and forth, contradictions wherever possible, because I think we learn more when witnesses contradict themselves and each other——

[Laughter.]

Senator Cranston [continuing]. Than when they all agree, or when we get one statement now and then another statement later on another side. It's much better to have a give-and-take discussion, so I encourage all of you to be forthright in your comments.

It's especially important that you speak up if you have a difference of opinion with anything that is said here. That's the best way for us to learn on this subcommittee.

I urge you to be brief so that everyone can participate. We have an outstanding group of witnesses. I'm grateful for the written testimony that you've provided. That will be included in the record. We have a lot of ground to cover and a short amount of time.

[The complete prepared statement of Senator Cranston follows:]

Opening Statement
Senator Alan Cranston
Oversight Hearing on
Fannie Mae and Freddie Mac
August 2, 1990

Good afternoon. Welcome to the second in the series of Senate Housing Subcommittee oversight hearings on the long-term financial soundness of the government-sponsored mortgage finance corporations, Fannie Mae and Freddie Mac.

These two corporations in recent years have taken on enormous importance to the nation's home mortgage finance system and to homeowners in every part of the country. Together, they support 60 percent to 70 percent of the country's conventional mortgage market. And last year alone, they financed 2 million home mortgages.

Fannie Mae and Freddie Mac provide benefits to virtually every community in the country. They reduce monthly mortgage payments for millions of families by greatly increasing the efficiency of the home mortgage market. They provide a stable and responsive source of mortgage finance that has enabled local mortgage lenders to continue providing affordable home mortgages -- without interruption throughout a period of historic restructuring and unprecedented turmoil in the mortgage lending industry.

When Federal Reserve Board Chairman Alan Greenspan recently appeared before the full Senate Banking Committee, he testified to the important public service provided by Fannie Mae, Freddie Mac and other elements of the secondary mortgage market. He noted that, while the thrift industry has been shrinking, "[t]he resulting void has been filled quite effectively for home mortgage borrowers, with highly developed secondary mortgage markets drawing funds in from elsewhere."

For the past three years, this Subcommittee has worked to revitalize national housing policy and to launch a tough-minded, nationwide effort to provide the more affordable housing that the country urgently needs. We are much closer to achieving that goal -- now that the Senate has overwhelmingly passed the National Affordable Housing Act, and the House yesterday overwhelmingly passed its own version of major housing legislation.

We have to recover much ground that was lost during eight critical years when the Reagan Administration was trying to dismantle federal responsibility for low-income housing and was mismanaging FHA. Antihousing ideologues in the Reagan Administration repeatedly tried also to weaken Fannie Mae and Freddie Mac. But bipartisan efforts in Congress blocked those efforts and made possible the great housing success of the last decade -- the emergence of a strong, innovative and responsive secondary mortgage market.

Now, as Congress completes legislation to recover lost ground, we also have to make sure we maintain those parts of the housing system that work and work well.

A key part of our challenge is to make sure that Fannie Mae, Freddie Mac and other elements of the secondary mortgage receive appropriate oversight -- both by Congress and the Executive Branch.

That oversight has to consider first whether Fannie Mae and Freddie Mac are faithfully carrying out their public mission as intended by Congress. Procedures must be in place to make sure that the activities of government-sponsored mortgage finance corporations primarily benefit

American homeowners, and families who are striving to buy a home, and low-income families who need affordable housing.

Second, and just as important, that oversight has to consider the financial soundness of the business strategies of Fannie Mae and Freddie Mac. Procedures must be in place to make sure that the government-sponsored mortgage finance corporations can continue to carry out their public purpose in changing economic conditions and without exposing taxpayers to unnecessary risk.

During the past decade, oversight of the government-sponsored mortgage finance corporations did not keep pace with their growing importance to the economy and their increasing sophistication. Under the past Administration, HUD shirked this responsibility, along with most of its other responsibilities. Executive Branch oversight was also weakened by having a separate regulator for Freddie Mac.

Congress has made clear its determination to strengthen oversight of Fannie Mae and Freddie Mac. Freddie Mac's charter was reformed to provide a more modern corporate structure and to clarify Freddie Mac's public purpose.

HUD was also given clear regulatory authority over both Fannie Mae and Freddie Mac. Treasury was given its proper responsibility to make sure that capital market activities of the government-sponsored mortgage finance corporations are coordinated with federal debt financing operations.

My objective is to make sure that HUD develops the capacity to carry out the sophisticated and effective oversight of Fannie Mae and Freddie Mac that the secondary mortgage market requires and that the country deserves. Top management at HUD will have to mobilize outstanding talent to fulfill the Department's oversight responsibilities. And HUD must have a tight timetable for implementing effective oversight procedures.

I believe that a good start has been made, but progress must not be slowed or weakened by lack of attention at the top or by routine bureaucratic obstacles.

An important focus of today's hearing is to check on HUD's progress in implementing its oversight responsibilities. We will review the Department's annual oversight reports on Fannie Mae and Freddie Mac, which the Department recently released.

I am looking forward to hearing the comments of our witnesses on those reports. But I also invite comments on steps that the Department must take to carry out fully adequate oversight of the government-sponsored mortgage finance corporations.

An additional important focus of today's hearing is to assess some of the specific suggestions for oversight of Fannie Mae and Freddie Mac that have been floated in recent months.

Some suggestions -- such as those relating to appropriate assessment of risk and capital requirements -- will have to be developed for inclusion in any effective oversight system.

Other suggestions are more problematic. One example is the suggestion that Congress create an entirely new system to oversee the financial safety and soundness of all government-sponsored enterprises, whatever their public policy mission. Frankly, I am not yet convinced that questions of safety and soundness of these enterprises can be isolated from questions about how they are carrying out their fundamental public mission.

On the basis of testimony submitted to this Subcommittee, I suspect that questions of public mission and questions of safety and soundness are inextricably intertwined.

I strongly doubt that it would be good public policy to give any one regulatory bureaucracy the power to control and interfere with federal housing policy and farm policy and education policy and other policy areas that can most effectively be carried out through a government-sponsored enterprise. As it is, the Federal government has enough difficulties in carrying out effective solutions to pressing national problems.

We have already seen how the Treasury Department -- during the Reagan years -- repeatedly used whatever regulatory levers they had to interfere with the ability of Fannie Mae and Freddie Mac to respond imaginatively to changing requirements in the mortgage market.

Still other suggestions have surfaced in recent weeks that are transparent efforts by some to achieve during the Bush Administration many of the destructive goals that they were unable to achieve during the Reagan Administration. OMB and the Treasury introduced into the Budget Summit negotiations a proposal for regulation of government-sponsored enterprises that is a naked grab for power.

I call upon the participants in those negotiations not to let the Budget Summit be misused as a way to jam sweeping changes into statute without adequate consideration of alternatives and their consequences. I will do all I can to make sure that the OMB/Treasury package is not imposed through the budget summit.

Each of our witnesses has had an opportunity to review the OMB/Treasury package. I invite your assessment of the details as well as of the package as a whole.

As you see, this morning's hearing will be conducted as a roundtable discussion. Participants in earlier roundtables have found that this format permits a more open and useful discussion of ideas among witnesses and Subcommittee members.

I encourage everyone at the table to be forthright in your comments -- it is especially important that you speak up if you have differences of opinion with anything that is said here. that is the best way for the Subcommittee to explore the issues before us this morning.

I also urge you to be brief in your comments so that everyone can participate.

We have an outstanding group of witnesses. I am grateful to have received your written testimony. That testimony will be included in the hearing record.

We have much ground to cover and a short amount of time.

(Do other Senators have opening statements?)

I would like Undersecretary Dellibovi to begin by providing us with a brief statement on the Administration's report. Please hold your remarks to 10 minutes so that we will have adequate time for discussion.

Senator **Cranston**. I'd like first to ask Chris Dodd if he has any remarks.

OPENING REMARKS OF SENATOR DODD

Senator **Dodd**. Well, Mr. Chairman, thank you for doing this. You've got a Herculean task with this many people here today to get through it all, but I commend you for doing it.

I have some questions. Whether or not I'll get an opportunity to raise them before everyone finishes their comments is another matter. But I'll certainly submit them if I don't have an opportunity.

Senator **Cranston**. All right. You're free to interrupt at any point like all of them are.

I'd now like to ask Under Secretary DelliBovi to begin by providing us with a brief statement on the administration's report on these matters. And I'd appreciate it if you'd hold your comments to 10 minutes so we have plenty of time.

Mr. **DelliBovi**. Thank you, Mr. Chairman, Senator D'Amato——

Senator **Cranston**. Senator D'Amato just arrived. Do you have any opening remarks to make?

Senator **D'Amato**. Mr. Chairman, why don't we hear from the Under Secretary and then I do have some remarks, but I would certainly like to hear from him.

STATEMENT OF ALFRED DELLIBOVI, UNDER SECRETARY, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Mr. **DelliBovi**. Thank you, Mr. Chairman, Senator D'Amato, and Senator Dodd. I would like to have my full statement included in the record.

Under Secretary Jack Kemp, HUD takes its regulatory responsibilities for Fannie Mae and Freddie Mac very seriously. Our activities are based on two premises. First, these agencies should strive to carry out their public roles in providing a steady supply of mortgage credit with particular attention to the credit needs of low- and moderate-income homeowners. Second, they must do this with a sufficient degree of financial safety and soundness to minimize the risk that they will become a financial burden on the taxpayers.

Obviously, it is necessary to strike a balance between the public purposes of the organizations as established by Congress and, the need for safety and soundness.

Any discussion of the safety and soundness of Government-supported enterprises quickly gets to the issue of capital requirements. I would just like to make the point that a discussion of capital requirements very rapidly comes to the easy-to-measure numbers. However, capital requirements that are easy to measure have been supplanted over the past few years with much more sophisticated requirements that actually recognize the differences in risks.

As our reports explain, it may be desirable to adopt an approach different from the use only of risk-based capital ratios, such as those that have recently been applied to banks and thrifts. As we approach HUD's oversight of Fannie Mae and Freddie Mac, we believe it is very appropriate to consider how to achieve a similar purpose by recognizing that there is no single magic number. This is particularly true in view of Fannie Mae and Freddie Mac's large size and the character of their business.

I would also like to recognize the fact that the Treasury and the GAO are conducting studies pursuant to FIRREA their reports. The first of their reports have been issued. The second one will be issued in 1991.

HUD intends to continue to monitor their work very carefully. HUD will make its recommendations based on the findings contained in both of those reports and its own analysis.

Let me just answer your question, Mr. Chairman, about how we are meeting our new responsibilities by reporting to you how Secretary Kemp has directed the Department to proceed both in performing our previous regulatory duties with regard to Fannie Mae more effectively, and in incorporating the newly imposed duties with regard to Freddie Mac.

We have established within HUD additional institutional support units for the Secretary. We have formed a financial institutions regulatory board within HUD to coordinate all of HUD's actions prompted by FIRREA, including the regulatory power over Fannie Mae and Freddie Mac. We are also creating a staff level office of regulatory functions within HUD which will evaluate Freddie Mac and Fannie Mae's compliance with statutory objectives on an ongoing basis.

In the past HUD has been criticized for not being diligent enough in carrying out its oversight responsibility. I can assure you that under Secretary Jack Kemp, no fair analysis will be able to reach this conclusion again. We intend to continue to perform the duties that Congress has given us and to do them as best as we can. And we believe we can do them very well.

I would now like to ask Assistant Secretary Weicher to summarize briefly the two reports that we issued in late June.

Senator CRANSTON. Thank you. Secretary Weicher?

[The complete prepared statement of Alfred A. DelliBovi follows:]

TESTIMONY ON FNMA AND FHLMC

by Alfred A. DelliBovi

before

SENATE BANKING COMMITTEE

August 2, 1990

Thank you, Mr. Chairman and members of the Subcommittee, for this opportunity to report on how HUD is overseeing the activities of the two housing-related government-sponsored enterprises -- the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC).

HUD's Responsibilities

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) gave HUD significant new responsibilities. The Secretary was placed in key roles in most of the major Federally-sponsored entities involved in housing finance. He is member of the Federal Housing Finance Board -- at the present time he is the chairman; he is a member of the Oversight Board of the Resolution Trust Corporation; and he is the regulator of FHLMC. He continues as regulator of FNMA. In addition, the Secretary is of course responsible for the Federal Housing Administration (FHA) and the Government National Mortgage Association (GNMA).

In all of these areas, HUD's activities are based on two premises: that these agencies should strive to carry out their public roles to provide a steady supply of mortgage credit, with special attention to the credit needs of low- and moderate-income homeowners; and that they must do this with a sufficient degree of financial safety and soundness to minimize the risk that they will become a financial burden on taxpayers. We believe that these are consistent objectives. It is necessary to strike a balance between the public purpose of the organization, as estabished by Congress, and the need for safety and soundness. This need exists in all Federal credit-related activities. We at HUD have just confronted the same need for balance in the case of FHA.

HUD has had regulatory power over FHLMC since the passage of FIRREA last summer and over FNMA since its rechartering in 1968. Our specific authorities for the two agencies include a prerogative to review and approve or disapprove agency plans for new programs, the obligation to monitor the agencies' debt to capital ratios, the right to require that some agency activities be directed toward low- and moderate-income families, and general regulatory power to act if the agencies' risks begin to appear excessive or their programs appear inappropriate relative to the Charter Act. HUD applies similar oversight to both FNMA and FHLMC.

HUD's Reports on FHLMC and FNMA

At the beginning of July, HUD sent detailed reports to Congress on both agencies. These reports cover FHLMC activities during 1989 and FNMA activities in 1988-89. The reports describe the agencies' roles in the secondary mortgage market, their business activities, and the interest rate and credit risks associated with their mortgage activities. We describe in some detail HUD's plans for dealing with concerns about FNMA's and FHLMC's risks and capital soundness. The HUD reports were produced on time, meeting the deadline specified by Congress in FIRREA.

The main issue on which further attention is needed in our judgment -- and we say this in the reports -- is the adequacy of FNMA's and FHLMC's capital. The reports recommend a stress-test approach similar to that used by the national securities rating agencies for many years to rate mortgage insurance companies. HUD, the Treasury Department, and the agencies themselves have all concluded that this is a highly useful approach to gain an understanding of the strengths and problem-areas of each agency's financial position at any moment in time. Over the coming year, we, at HUD, intend to improve our stress-testing capacity, including the provision of necessary financial information by FHLMC and FNMA.

It needs to be emphasized, in connection with our plan for improved analytical capacity, that HUD's authority as regulator to ensure that the agencies maintain adequate capital is limited by statute. We believe that the statutory requirement for each agency to hold capital sufficient to keep its debt-to-capital ratio below 15-to-1 (or a larger ratio if established by the Secretary) is not a very relevant standard for either FNMA or FHLMC today. Each agency has large off-balance sheet businesses in mortgage pass-through securities which are not counted in the regulatory debt-to-capital ratio. The ratio also fails to recognize differences in risk among various kinds of business in which the agencies engage.

In the case of banks and thrifts, capital requirements like this have been supplanted over the past few years with more sophisticated requirements that recognize differences in risks. The Office of Thrift Supervision, for example, has been developing a method for measuring interest rate risk, which it plans to use in the determination of required capital for thrifts.

I believe that it is appropriate to consider how to achieve a similar purpose in the Federal oversight of FNMA and FHLMC. As our reports explain, it may be desirable to adopt an approach different from the use of risk-based capital ratios like those applied to banks and thrifts, in view of FNMA and FHLMC's large size and character of business. Congress has asked both GAO and the Treasury Department to report on the capital adequacy of all the GSEs. Two reports are required for both agencies, one in 1990 and one in 1991. HUD intends to monitor their work carefully, and to make recommendations based on their findings and our own analysis.

HUD's Regulatory Actions

In addition to the annual reports, we have established a timetable for the issuance of administrative regulations governing HUD's exercise of authority over FHLMC. As we draft these regulations for FHLMC, we will also update the FNMA regulations, which have not been revised since 1978. We held a public hearing on July 31, 1990 on regulatory issues, to enable us to receive the broadest possible range of suggestions on how to oversee these agencies. Seventeen witnesses presented testimony and the two major rating services, Moody's and Standard and Poor's, submitted written statements. We were very pleased with the interest shown and we plan to study the comments and suggestions carefully. Our plan is to complete the entire regulatory cycle, which includes issuance of proposed regulations and a public comment period prior to the issuance of final regulations, by April, 1991.

To meet our new responsibilities, as well as to perform our previous regulatory duties more effectively, we have established additional institutional support units for the Secretary.

We have formed a Financial Institutions Regulatory Board to coordinate all of HUD's actions prompted by FIRREA, including the Secretary's regulatory power over FNMA and FHLMC, his membership on the RTC Oversight Board, and his chairmanship of the Federal Housing Finance Board. This is the first time any such entity has existed in HUD.

Also, we are creating a staff-level Office of Regulatory Functions in HUD, which will evaluate FHLMC's and FNMA's compliance with statutory objectives on an ongoing basis. This office will have an interdisciplinary staff of lawyers, economists, accountants, and professionals with other needed skills, to ensure appropriate, broadly-based oversight of the agencies.

We have taken seriously our right of review on proposed new programs of the agencies. Within recent weeks we have received requests for new program approvals from both FNMA and FHLMC. The Department has requested additional information from both agencies and is proceeding expeditiously to decide whether these requests are consistent with the public purposes of these agencies and whether they satisfy reasonable standards of safety and soundness.

Conclusion

In the past, HUD has been criticized for not being diligent enough in carrying out its oversight responsibility. I can assure you that no fair analysis will reach this conclusion in the future. The organizational changes I have described, the annual reports which we recently submitted on both agencies, our care and promptness in responding to new program requests from both agencies, and our plan to issue regulations governing our relationship with FHLMC and to revise the regulations governing our relationship with FNMA, all demonstrate our commitment to carrying out the FIRREA process. We will continue to perform the duties that Congress has given us.

I am grateful for this opportunity to discuss HUD's work with you. Assistant Secretary Weicher will now discuss our reports in further detail.

STATEMENT OF JOHN C. WEICHER, ASSISTANT SECRETARY FOR POLICY, DEVELOPMENT AND RESEARCH, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Mr. WEICHER. Thank you, Mr. Chairman, Senator D'Amato, Senator Dodd.

As the Under Secretary mentioned, we submitted the annual reports that are required under FIRREA at the beginning of July. This is our first annual report on Freddie Mac and our third report on Fannie Mae, the report on Fannie Mae covers the last 2 fiscal years; the report on Freddie Mac covers last year.

The reports give particular attention to the risk that agencies could, at some point, impose costs on the Federal taxpayer. We analyzed both credit risk and interest rate risk, both the risk that the agencies could be harmed by significant defaults in excess of what they are planning for and the risk of an interest rate increase which could reduce the value of the portfolio, particularly in the case of Fannie Mae, where there is $108 billion loan portfolio.

We conclude that the likelihood of significant financial losses for either under an interest rate problem or credit problem is low at this point, but nonetheless present to some extent. We analyzed and we propose to analyze further both interest rate risk and credit risk through stress tests where we postulate a hypothetical adverse economic scenario and look at how long the agencies would be able to withstand such a scenario.

This is a common procedure in evaluating financial institutions and other businesses. Both agencies have been developing stress test models. We encourage them to do that, and we intend to work with them.

We are also recommending to the agencies the use of mark-to-market accounting, and analysis of the stressful economic scenarios in terms of their effect on the mark-to-market values of both enterprises. We think mark-to-market values reflect more accurately and quickly how changes in economic conditions alter the financial soundness of an institution.

Mark-to-market accounting would have been extremely valuable in the case of thrift institutions over the last decade. Both Fannie Mae and Freddie Mac have acknowledged the usefulness of mark-to-market analysis. Freddie Mac published an estimate of its mark-to-market value in December of last year. As we were in the process of preparing these reports, Fannie Mae indicated a willingness to begin reporting its net worth on a mark-to-market basis, as well.

We have begun to work with the two agencies to ensure the use of common methodologies. We held an exploratory meeting with them on July 16 to begin that process, and we think that it will be fruitful in the course of the coming months.

We regard these as reasonably detailed reports, but we intend to ask for more information for next year's reports. We want more detail on loan-to-value characteristics of the mortgage portfolios, more information on default experience, as well as information on the mark-to-market analysis.

We are in the process of preparing regulations, and we plan to introduce the requirements for new information into the regulations. Overall, within the next year, we will analyze further the risks and benefits associated with the two enterprises, and we will expect, as we prepare next year's reports, to make use of both past analysis and next year's analyses by the Treasury and GAO, and to learn from other people, including those who are here on this panel.

[The complete prepared statement of John C. Weicher follows:]

TESTIMONY ON FNMA AND FHLMC

By John C. Weicher

before

SENATE BANKING COMMITTEE

August 2, 1990

Thank you, Mr. Chairman. As the Under Secretary has mentioned, at the beginning of July, HUD transmitted annual reports to Congress on the activities of FNMA and FHLMC. These reports addressed capital adequacy as a major concern, for obvious reasons. Previous HUD reports on FNMA have noted insufficient capital as a potential problem. This spring's Treasury report on government-sponsored enterprises concluded that FNMA and FHLMC should have greater capitalization.

Agency Risks

The reports give particular attention to the risk that the agencies could, at some point, impose costs on the Federal government and taxpayers. A major source of risk is credit risk, which is present in both the portfolio and mortgage-backed security (MBS) operations of the agencies. For instance, FNMA and FHLMC take on credit risk when they guarantee investors full payment of interest and principal on their mortgage-backed securities. At the end of 1989, FNMA had $238 billion in MBSs outstanding, and FHLMC had $283 billion. Increases in default rates and foreclosure loss rates, if large enough, could cause substantial increases in loan loss chargeoffs and overall losses for the agencies.

The other major source of risk is interest rate risk, which is a particular problem for FNMA because of its large $108 billion portfolio. Increases or decreases in interest rates, if they are large enough, could cause interest income from mortgages in FNMA's portfolio to become less than interest costs on its debt securities. If such an environment were to persist for a period of time, FNMA could begin to experience significant financial losses. In the FNMA report, we demonstrate that the likelihood of this happening is low, but nevertheless present. FHLMC, on the other hand, maintains a small mortgage portfolio -- $16 billion at the end of 1989 -- and thereby minimizes its interest rate risk.

Stress Tests and Mark-to-Market Analysis

The reports conclude that it is appropriate to evaluate agency risks and capital adequacy by means of stress tests, where a hypothetical, adverse economic scenario is postulated, and its potential effects on agency cash flows and financial solvency are projected. The longer an institution maintains positive equity during stressful times, the better protected are its creditors.

The stress-testing approach suggested in our reports as a basis for Federal oversight of agency capital is similar to that used by private securities rating agencies. Moody's Investors Service has developed a stress test that estimates how long a mortgage insurer would survive during a "worst case" scenario like the Great Depression, where housing prices would decline for 10 percent per year for four years. FHLMC has adapted the Moody's approach to their business. FNMA also performs stress tests, defining a "worst case" environment by extrapolating to the whole nation the levels of default and loss rates that FNMA has experienced in the southwest region over the past few years.

HUD will encourage both agencies to continue their development of stress test models. In addition, HUD intends to expand its stress testing capacity during the next year. This will complement the cash flow model of FNMA which HUD has developed to simulate the effects of interest rate changes on FNMA's financial position.

Another key feature of HUD's recommended approach is the use of mark-to-market accounting, and analysis of stressful economic scenarios in terms of their effects on mark-to-market values. Mark-to-market values reflect more accurately and quickly how changes in economic conditions alter the financial soundness of an institution. If thrifts had used mark-to-market accounting, it would have possible, at an early stage, to have seen the negative effects from the substantial increases in interest rates in the late 1970s and early 1980s -- specifically, low coupon mortgages would have been carried at their lower market values, rather than at their higher book values. Mark-to-market accounting also includes the value of income produced by off-balance sheet assets, such as mortgage-backed securities.

Both FNMA and FHLMC have acknowledged the usefulness of mark-to-market analysis of their positions. FHLMC began publishing estimates of its mark-to-market value in December, 1989. As we were in the process of preparing these reports, FNMA indicated a willingness to begin reporting its net worth on a mark-to-market basis as well. We think this is appropriate and desirable. We have begun to work with these two agencies to ensure the use of common methodologies. We want to develop a methodology that is broadly compatible with methods that are being considered by the Office of Thrift Supervision for use by savings associations.

Approach to Agency Capital

We are working to improve our understanding of the effects of capitalization on agency risks, as well as the implications of increased capital requirements for the ability of the agencies to carry out their programs in the public interest. As Under Secretary DelliBovi noted, HUD does not have authority to change the way capital is assessed for official purposes -- that requires legislation. Furthermore, the current, statutory debt-to-capital standard does not provide an accurate picture of the agencies' capital position, for four reasons -- (a) it ignores the credit risk associated with off-balance sheet guarantees; (b) it includes subordinated debt in the definition of regulatory capital; (c) it is not tied to the risks that the agencies take; and (d) it is based on historical cost accounting conventions.

Therefore, we have emphasized a broader stress-testing approach, which will enable HUD to comment on FNMA's and FHLMC's capital adequacy on an ongoing basis, and which could also be used as the basis for reformulating the government's official standards for capital adequacy, if HUD decides to recommend such changes to Congress.

Our report also emphasizes the need for more information on agency risks. This will include more detail on loan-to-value characteristics of FHLMC's and FNMA's mortgage portfolios than they have given us in the past, and information on their default experience, in addition to information for the mark-to-market analysis that I have already mentioned. We plan to introduce requirements for new information into the regulations as they are developed during the next year.

Agency Benefits

In the discussion of risk, it is important not to lose sight of the benefits provided through these agencies. The secondary market activities of the agencies have enabled local markets for housing credit to become integrated nationally. Mortgage rates and availability are no longer driven by thrift deposit flows as they were in the 1960s and 1970s, but by conditions in the overall capital market. The secondary market has opened up many potential sources of funds for homeowners to borrow at market rates.

Homeowners also benefit from lower interest rates resulting from FNMA's and FHLMC's agency status, estimated at 10 to 50 basis points. Investors who buy MBSs guaranteed against issuer default by FNMA or FHLMC, or who buy debt securities issued by FNMA and FHLMC, tend to require lower yields because they perceive an implicit government guarantee of the agencies, even in the face of explicit disclaimers carried on their MBSs and debt.

Lower interest rates also result from the enhanced liquidity of mortgages attributable to the standardized, agency MBS. Because MBSs can trade more quickly in a much broader capital market involving less information cost, MBS investors do not require as high a yield as portfolio investors. Because of the intense competition that has always existed between FNMA and FHLMC, the benefit of this cost saving advantage is passed on to ultimate borrowers in the form of a lower interest rate. As regulator, HUD will make every effort to ensure that this competition continues.

Conclusion

Within the next year HUD will seek to analyze further the risks and benefits associated with FNMA and FHLMC. Our next annual reports will address the capital adequacy issue in much greater specificity, including an assessment of some alternative approaches to capital standard-setting. Perhaps the crucial question concerns how an appropriate balance is to be struck between the desire for maximum security for taxpayers that FNMA and FHLMC will remain financially sound, and the desire for significant activity in the public interest by the agencies. With the anticipated issuance of the final Treasury and GAO studies on capital adequacy next summer, we anticipate a period of comprehensive assessment of the agencies' capital standards, and appropriate changes in the Government's regulatory capital approach at that time. HUD's reports will contribute to this, by applying the advanced analytic techniques and enhanced information base that I have described.

Senator **Cranston**. Thank you very, very much.

As I think you all know, HUD is charged with the responsibility of providing an annual report to this committee on the financial status of Fannie Mae and Freddie Mac. In previous years, the reports have been notoriously late, and I want to thank you, and particularly you, Al, for the timeliness of your reports now and for the information you've given us.

All of you in the roundtable here have before you a discussion guide. And I'd like now to refer you to the first set of questions. I'm going to eliminate a few of them that I don't think we need to get into in detail. But let me read about four questions that I'd like us now to discuss together with whoever would like to start off with their comments.

One would be: how do you assess the Department's analysis of the financial conditions of Fannie Mae and Freddie Mac?

What are the most important changes that have occurred recently in their activities?

How do you assess steps that have been taken to reduce the interest rate and credit risk that they undertake?

And, finally, what is the most appropriate way to assess the likelihood of either Fannie Mae or Freddie Mac becoming a cash drain on the treasury?

Who would like to lead off?

Yes, Mr. Stanton.

THOMAS STANTON, COUNSEL, OLWINE, CONNELY & CHASE, WASHINGTON, DC

Mr. **Stanton**. Senator, I thought the HUD report did a commendable job with respect to credit risk and interest rate risk. However, those are only some of the different kinds of risk a financial institution can undertake.

Both the Comptroller of the Currency and the FDIC have reported that management risk and operations risk are two of the most important of the kinds of risk that have to be dealt with. So, in answer to the first question, I would say the HUD report fails to address important issues, for example, dealing with equality of management information and control systems.

We have from The Washington Post of July 19, a story involving a Richmond mortgage banker that sent some $160 million of mortgages to Fannie Mae with about 25 percent losses. This is a problem involving operations and management risk. If we will recall Continental Illinois Corporation and Penn Square, Penn Square was much more crooked and much more efficient and managed to send to Continental Illinois, essentially in a secondary market, over a billion dollars worth of losses that brought down the company.

I believe it's essential that HUD get involved in elevating management and operations risk. It has a statutory responsibility to examine these two institutions. I believe it's essential that it do so.

CARYL S. BERNSTEIN, EXECUTIVE VICE PRESIDENT, GENERAL COUNSEL AND SECRETARY, FEDERAL NATIONAL MORTGAGE ASSOCIATION [FANNIE MAE], WASHINGTON, DC

Ms. **Bernstein**. Mr. Chairman, as to Mr. Stanton's statement about the Friedlander story that was in The Washington Post, it was Fannie Mae's own efforts that several years ago found that these people were defrauding us. We announced that we were suing them for $20 million and have received a judgment for triple damages.

This was a case of fraud. So we have a judgment for $58 million. One of the principals has already pleaded guilty. The U.S. attorney is taking steps to get the rest of the family. And this is a case that is being completely blown up by him. We have handled this responsibly.

We now have loan-level detail for all of our mortgages and are much better able to know what we have. And we are careful and this is—I would support a red herring that makes for good headlines, but nothing more.

Mr. **Stanton**. Mr. Senator, if I might respond, since my name has been involved. My point is not whether a great danger exists, rather that HUD is not checking to answer that question.

At the last hearing in February, this subcommittee was told by the Fannie Mae witness, "We feel that we have the finest management information systems in the business." Three months later, the Treasury Department issued a report saying "Fannie Mae has not yet developed the capability to query its LASER system for data in an accurate, consistent, or timely manner."

My point is only that self-reporting is not adequate assurance for the Government because we have $650 billion of securities that taxpayers are standing behind.

LELAND BRENDSEL, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, FEDERAL HOME LOAN MORTGAGE CORPORATION [FREDDIE MAC], WASHINGTON, DC

Mr. **Brendsel**. Mr. Chairman, thank you for the opportunity to appear here today. I would comment and observe that you now see one of the finest examples as to why the Government-chartered corporations have such effective oversight and scrutiny. There isn't virtually a thing that we do or don't do that doesn't appear in the press, isn't focused on by stockholder analysts or whatever, that gets a full and open hearing.

Also I think we shouldn't make too much of any individual situation that appears in the press, since frequently there is a lot more behind the scenes than what is just reflected and how the ongoing activities of the companies to manage their business.

Also, with regard to Tom Stanton's management comments about management and operations risk, there are a number of safeguards in place that really focus on ensuring quality of management, control of operations risk, ranging from Presidential appointees on a board of directors—and, frankly, very high quality boards of directors—through auditing by outside public accounting firms and auditing by GAO.

We had an audit by GAO this year. And additionally, of course, as appropriate for the regulator in fact to come in and examine our operations on an individual basis.

One final comment with regard to HUD's annual report on Freddie Mac—this is our first year in terms of an annual report from HUD, since we only became recently regulated by HUD—I was very impressed by the thoughtfulness and the insight that they showed into and understanding of the operations of Freddie Mac, the risks that we face—and the two primary ones are credit risk and, secondarily, interest rate risk—and also the thoughtful approach they are taking with regard to how they are going about establishing a way to regulate Freddie Mac in the best way that will ensure that we accomplish our mission while maintaining safety and soundness.

DAVID F. SEIDERS, PH.D., CHIEF ECONOMIST AND SENIOR STAFF VICE PRESIDENT FOR MORTGAGE FINANCE AND HOUSING POLICY, NATIONAL ASSOCIATION OF HOME BUILDERS, WASHINGTON, DC

Mr. **Seiders**. Senator, I also thought the HUD report was very well done. I would encourage HUD or whoever else does this stress test, and I'm saying this from the point of view of an economist, not to apply unreasonable degrees of stress so that it goes beyond the realm of the relevant economic scenarios.

Some of the things I've seen suggested are far beyond anything that I, as an economist, or most of my colleagues would expect in anything like the foreseeable future. For example, a 15 percentage point increase in interest rates has been suggested as one of the conditions under which the agency should be able to survive for, like, 10 years.

I wanted to ask John Weicher what kind of an interest rate run-up he employed to get some concern about Fannie Mae's interest rate risk situation?

Mr. **Weicher**. Mr. Chairman, I'd be happy to respond to that, because I think there is a little bit of a misunderstanding. This came up also 2 days ago in the hearing which we held on regulatory issues, in which we had a number of witnesses from organizations that are concerned with Fannie Mae and Freddie Mac.

We do not forecast an interest rate run-up of 15 percent for 10 years. We asked the question, under what circumstances would Fannie Mae suffer losses that would seriously run the risk of bankruptcy. And this is what came out of the model.

I think each of us, as we saw this, did a double-take, said, "Well, if that is what it is going to take, do we think that is likely?" No, we do not think that is likely. I know of no one who thinks that is likely. But we saw our job as finding out what the circumstances would be, not trying to forecast the economic future.

I have been an economic forecaster once or twice, and I don't think that is quite the way we should proceed. We should see what the worst thing would be and go from there.

Senator **Cranston**. Can we go on to the second point? If any of you can indicate what you think are the most important changes that have occurred recently in the activities of Fannie Mae and Freddie Mac.

ELDAD COPPENS, JAMES D. WOLFENSOHN, INC., NEW YORK, NY

Mr. **Coppens**. I am here representing James D. Wolfensohn Incorporated. We have been working with Fannie Mae for the better part of the past year to help them assess their capital position and to assess various measures of capital adequacy.

And in doing that study, I would like to say that two things that stood out in our analysis are—and these address the main risks that these companies face, which are credit risk and interest rate risk. On the credit risk front, we believe that one of the main determinants of credit risk is the weighted average loan-to-value ratio of the loans that Fannie Mae is backing.

And if you would look at a chart of the average loan-to-value ratio of Fannie Mae's portfolio and off-balance sheet mortgages, you would see a steadily declining trend over the past 8 years or so. And I think that this reflects the tightened underwriting standards that Fannie Mae has deliberately put in place since their experiences of the early 1980's.

On the interest rate side of things, we're all familiar with what happened with Fannie Mae in the early 1980's, which was fundamentally a mismatched portfolio, long-term assets being funded by short-term liabilities. I think Fannie Mae and other financial institutions have learned their lessons from the experiences of the early 1980's when interest rates rose to unprecedented levels.

And Fannie Mae, in particular, has an ability that is not available to many other financial institutions of funding their portfolio assets with longer-term maturities of debt. And recently Fannie Mae has taken another step of issuing callable debt, which addresses a unique aspect of mortgage credit risk, which is the risk of prepayment in a declining interest rate scenario.

If you can create common characteristics on both sides of the balance sheet, it enhances your ability to manage risk. And the indicator of their success in doing so is the decline of the duration gap of their portfolio, and that's a technical term, but what it is is an indicator of the amount of interest rate risk that the company is facing at any moment.

Senator **Cranston**. Ms. Dolbeare.

CUSHING DOLBEARE, CHAIRPERSON, NATIONAL LOW INCOME HOUSING COALITION, INTERIM EXECUTIVE DIRECTOR, NATIONAL COALITION FOR THE HOMELESS, WASHINGTON, DC

Ms. **Dolbeare**. I am Cushing Dolbeare, Chair of the National Low Income Housing Coalition.

As most of you know, our major concern is more with the subsidized low-income housing programs, but I am—one point I want to make here, I think, is the very obvious one that, to the extent that the private sector can go down in the income scale and serve people of moderate income or low income, that lessens the need for Federal subsidies. And I think that it is extremely important to us that, in this estimate and evaluation of the economic risks of loss in Fannie Mae and Freddie Mac's activities, that we not lose sight of the public purpose which those entities serve and serve very well. And it seems to us that it is worth taking some risks.

About 5 years ago, I participated in a GAO symposium on Fannie Mae. And I looked up my comments there and discovered that I had said that one of things that I thought was important about Fannie Mae, which 5 years ago Fannie Mae wasn't really doing, was making an affirmative effort to deal with low-income housing needs and provide assistance and partnership with other organizations.

And I think one of the recent changes that Fannie Mae has made which is very significant has been its participation in a range of low- and moderate-income initiatives. And I would hope that, as a matter of public policy, and I would hope that the HUD reports in the future, as a matter of public policy, would look not just at financial soundness, but also at the contribution which Fannie Mae and Freddie Mac are making directly to assist low-income housing programs and indirectly by serving the lower half of the income distribution without subsidy to lessen the needs for subsidies.

Ms. BERNSTEIN. Mr. Chairman, I ask leave to submit for the record Fannie Mae's report on its special low-income housing record. I would also like to report that during 1989, measuring our one-to-four family mortgage support, if we look at 2½ housing, costing 2½ times the median income of each SMSA, Fannie Mae's support for low and moderate income housing just from its regular programs, was 38 percent of the number of mortgages that we purchased, which I think is a very strong record.

In addition, may I say that in observing going back, the capital ratios that Fannie Mae has proposed as appropriate for our safety and soundness do include a piece for management risk. It does not include only interest rate risk and credit risk.

So we believe that we are appropriately recommending a ratio that deals with all the risks. And we do think that the HUD report was quite well done, particularly on the interest rate risk test. As to credit risk, the HUD report just commented on the work that Treasury had done.

And, Mr. Chairman, we have, at Treasury's request, prepared some comments about their report and, with your permission, I would like to also submit those for the record with this hearing. I won't go into them now.

Senator CRANSTON. Thanks. We're glad to have those for the committee files.

Ms. BERNSTEIN. Thank you very much.

BART HARVEY, DEPUTY CHAIRMAN, THE ENTERPRISE FOUNDATION, COLUMBIA, MD

Mr. HARVEY. Mr. Chairman, if I may add to Ms. Dolbeare's remarks, as far as you were asking about new business lines, and Ms. Dolbeare brought up, of course, the public purpose policy of Fannie and Freddie.

At the Enterprise Foundation, we have worked very closely with both Freddie Mac and Fannie Mae in this expansion to get to the non-conventional market. I think, as Carol has said, their average size of loan already serves many low- and moderate-income housing people, families across the country. The same with Freddie Mac.

But they have made major efforts in both of these Government-sponsored enterprises to reach down into the non-conventional market. Fannie Mae's effort is about $4 billion which has been committed through a variety of programs. Freddie Mac is making that same effort and has been a leader in the multifamily field, as well.

It is not inconsistent with prudent lending practices, and it is our belief as we have invested side by side with both agencies in tax credits and look at the underwriting standards, that they're very secure loans that are being made, so that they are serving both their public purpose and they are doing it on a sound underwriting basis and criteria. There is no disparity between their reaching out to the lower income individuals and also keeping their standards of risk underwriting up.

ALLAN HUNT, EXECUTIVE DIRECTOR, VERMONT HOUSING FINANCE AGENCY, BURLINGTON, VT

Mr. HUNT. Mr. Chairman, my name is Allan Hunt. I am Director of the Vermont Housing Finance Agency, and I also represent the National Council of State Housing Agencies today.

I want to echo Bart and Cushing's point. We have been working with Fannie Mae on a number of initiatives to assist lower income people, both on a home ownership and rental basis and in Vermont, as well as number of other states throughout the country.

We are very concerned that any tightening of the current regulatory environment of either Fannie Mae or Freddie Mac would have detrimental effects on our ability to work with them on delivering housing programs to our constituency. We do believe, as Bart has said, that they are exercising a great deal of diligence in involving themselves with these programs, and we frankly think that there's a lot of opportunity for them to do more with us in other states throughout the country and would encourage them to do that.

So we are very concerned that we not have a situation where they are constrained from participating with us and the other organizations here today.

Thank you.

Senator CRANSTON. Thank you very much.

ROBERT EDELSTEIN, COCHAIR, CENTER FOR REAL ESTATE AND URBAN ECONOMICS, UNIVERSITY OF CALIFORNIA AT BERKELEY, CA

Mr. EDELSTEIN. I would like to direct my comments to a major shift in the mortgage markets over the last 10 years to more exotic mortgages that are being securitized.

And this proclivity is likely to continue. This will make the bulk of the portfolios of Freddie Mac and Fannie Mae more risky than their older lines of business. And that doesn't mean that they shouldn't do that, but is does mean that there are risks that are probably not fully recognized.

Every time a new mortgage instrument or mortgage-backed security is introduced, there seems to be a significant learning period, sometimes a painful one at that. I believe that basically and fundamentally Freddie Mac and Fannie Mae are well organized to examine and evaluate credit risks and interest rate risks, but I feel the Government is being exposed to risks that it hadn't been historically. And that should be brought into the evaluation.

I also think that HUD's report was first class, and really was well balanced.

Senator CRANSTON. How do you take steps take to reduce the interest rates and credit risks that Freddie and Fannie Mae undertake, and what is the most appropriate way to assess the likelihood of either Fannie or Freddie becoming a cash drain on the treasury? Ms. Berger.

CAROLE BERGER, SENIOR VICE PRESIDENT, C.J. LAWRENCE, MORGAN GRENFELL INC., NEW YORK, NY

Ms. BERGER. Good afternoon. I am Carole Berger with C.J. Lawrence. I have been an equity analyst for 15 years, specializing in commercial banks and other financial institutions. I have been following Fannie Mae since 1982. So I am very familiar with the company over the period of its restructuring.

The point I would really like to bring out is stockholder-owned is not synonymous with risk. What you see, what managers of financial institutions really strive for is maximizing shareholder value over the long term. And that really requires the management of risk, not the avoidance of risk. It requires understanding the risk and the ability to price for it in order to compensate both stockholders and bondholders with a reasonable, competitive rate of return.

Fannie Mae has built capital over this period, just as it has built reserves. But that's only part of the way that they've tried to lessen the risk. I think they've done a terrific job at other balance sheet management—a topic which I don't hear enough discussion here today. Further reducing interest rate risk is part of such management. And they have worked consistently over the years to address this risk.

On occasion it has been suggested that stockholders may be making too much money—the fact that the stock price of Fannie Mae has done very well. Simplistically the share price has risen because investors are willing to pay more for Fannie Mae's equity because of that reduced risk.

There's a good example in 1986. Fannie Mae sold $9.5–$10 billion of assumable mortgages from their portfolio, they were profitable assets at the time. But assumable mortgages are very hard to match-fund in the market, and if interest rates would have gone back up, the likelihood is that they would have been unprofitable once again.

So Fannie Mae made a decision in 1986 to sell them without any knowledge at the time of whether interest rates were going to go upwards or sidewards or downwards. It was however a prudent decision to make. At the time, the average yield on those assets when they sold them was roughly 9¾ percent, and the cost of funds issued that year was about 180 basis points below that.

So basically they gave up for—as far as the stockholder was concerned—$180 million of annual income to reduce that interest rate risk from the balance sheet. In 1986, that basically cut their reported earnings in half. But during that period of time (over the course of 1986) the stock actually went up over 50 percent because stockholders were willing to pay more for a reduced income stream because of the perception and the reality of reduced risk to future income streams.

I think it's a good example, and only one of many I could give you. Fannie Mae has done an extraordinarily good job of reducing risk, not only by building capital, but by reducing the risk to the balance sheet.

Senator **Cranston**. Any other comments on this? Yes?

Mr. **Seiders**. I would like to say that as far as Fannie and Freddie serving the housing market and keeping the flow of mortgage credit going, the mortgage-backed securities programs work extraordinarily well. I think if there's one of the things to be watched, it is the portfolio positions of the two enterprises.

Having a large portfolio without proper risk management, of course, is what brought Fannie into deep trouble in the early 1980's. They have since then taken steps to concentrate more on the mortgage-backed securities program, and it's something that Freddie Mac has always done.

So I think that watching the size of the asset portfolio and the degree of leveraging of debt is something that, I'm sure, HUD will be watching very carefully.

Senator **Cranston**. Yes.

Mr. **Stanton**. In answer to the question, what's the appropriate way to assess likelihood of changes in business operations that might create more risk, at the February hearing there were two witnesses, professors who had been retained by Freddie Mac. And both of those witnesses, Professors McConnell and Flannery, pointed out that it is essential for the Government to promptly monitor any change that might take place in management strategies that increases risk beyond acceptable levels.

One can also read the Wolfensohn report and find a similar call for surveillance. HUD has a statutory responsibility to examine Fannie Mae and Freddie Mac. This was enacted in 1968 for Fannie Mae and Freddie Mac in 1989. HUD has not used this authority.

I respectfully suggest that one of the most important lessons from the savings and loans debacle is the need for a capable and effective examination staff. This is not burdensome on the regulated entities, but it simply permits the Government to check promptly on the degree of risk being taken by an institution.

Mr. **Brendsel**. Mr. Chairman, let me comment a little bit about Freddie Mac's strategies and changes in strategies. With regard to the interest rate risk and credit risk, historically—in fact, way back in the 1970's, when the corporation was chartered by Congress—Freddie Mac has followed an interest rate risk strategy of securitizing virtually everything that we purchase, meaning we are exposed to no changes in interest rates at all with regard to credit risk.

It was the vision of Congress, in fact, in chartering us that said that we should purchase only investment-quality mortgages that would be attractive to the private investors, as well. Over the course of time, we have focused a lot on managing credit risks with the result that our loss experience has really been one of the lowest in the industry.

And, of course, from time to time, one must always change underwriting requirements as we have done in our multifamily program and as we do in our single family program from time to time.

I think probably the most important fact to note about the exposure of either Fannie Mae or Freddie Mac to credit risk is that virtually all of our assets, whether on balance sheet or off balance sheet, are mortgages on people's homes and that they are one of the highest quality investments known today. Also, our mortgages are backed up by homes worth twice that amount.

We have about $300 billion in mortgages and $600 billion in homes backing us up. That would mean that we could survive, according to our analysis, something equivalent to a Great Depression in terms of collapse of real estate values.

Senator CRANSTON. Let me ask one final question on this point. Do any of you see any looming or potential risks that require any precautionary steps at this point?

Ms. BERNSTEIN. In fact, we have the opposite: no looming risks. We have had the administration, the GAO, the Treasury, and HUD saying that there is no risk at the moment, that no serious problem is posed.

Mr. STANTON. Sir, I guess I suggest when the Government is standing behind $650 billion of securities, we had better know the answer to that question. In other words, the absence of that information is not something that is reassuring unless we are examining the two institutions.

For example, American Banker just had an article on Sallie Mae, which stock has lost 22 percent of its value in the last 2 weeks. Sallie Mae was widely regarded as virtually risk free. Sallie Mae has no financial regulator. We simply don't know the extent of financial risk until we check.

And it is not a criticism. I have stated in the earlier hearing, I have the highest regard for the managers of these institutions. But with that kind of money at stake, it is not a statement of disrespect to say we need to institute effective examination and oversight of safety and soundness of Fannie Mae and Freddie Mac.

Senator CRANSTON. Are those in the works adequately, in your opinion, now?

Mr. STANTON. No, sir. If we look at the bank regulators, what we find is that they assess the regulated institutions a modest fee, so that they can pay their examiners above the civil service rates. You simply can't get a lot of financially capable examiners and other analysts to stay in Government for long periods of time. In fact, if you look at some of the really good people at Fannie Mae and Freddie Mac, they have come from HUD. They get much better salaries in the private sector.

So what we found with the bank regulators is, you've got to assess the regulated institutions and set up a structure so that you can retain and keep an effective examination corps and an effective oversight staff.

Senator CRANSTON. Is there any dissent from what Mr. Stanton has said?

Yes?

Mr. **Edelstein**. Not dissent, exactly, but I think your question was, is there any immediate danger. And I think if you use——

Senator **Cranston**. No, I didn't say immediate.

Mr. **Edelstein**. OK. Whatever, I'd divide it into the near term versus long term. In the near term—and you can decide what period of time that is; I'd say over the next 3 or 4 years—given the mark to market accounting that we've observed, there is a sufficient financial cushion that would permit Fannie Mae and Freddie Mac to survive. I think there really is no immediate risk.

Over the longer term, I agree with Mr. Stanton's point that you need a quality control system which analyzes the management system. But that can be done, not by looking and examining every transaction at Freddie Mac or Fannie Mae at every point in time. You can have a quality control system that does random auditing and spot checking, and has an early warning system that can efficiently use Government resources.

Mr. **Hinkle**. Mr. Chairman.

Senator **Cranston**. Yes.

W.H. HAL HINKLE, CHAIRMAN, MORTGAGE-BACKED SECURITIES EXECUTIVE COMMITTEE, PUBLIC SECURITIES ASSOCIATION, NEW YORK, NY

Mr. **Hinkle**. Let me introduce myself. I'm Hal Hinkle, the National Product Manager for the Mortgage Division at Goldman Sachs, and the Director of Mortgage Banking. And I'm here today on behalf of the Public Securities Association which represents the capital markets and, in turn, investors.

I would suggest that, in general, we concur wholeheartedly with the findings of the HUD report, that there's no immediate danger. I would suggest that there is a fear in the eyes of some investors which doesn't have to do directly with the safety and soundness, but rather it has to do with the regulatory process. If there are sudden shifts in the regulatory process for the oversight of Fannie Mae and Freddie Mac, which aren't given due consideration, the sort of deliberate approach that Congress usually takes, that unknown outcomes inexplicit perhaps treatment of existing securities could represent a threat to current investors. And that may cause an effect on how their securities are viewed in the marketplace.

Now, that's not a risk of the operations of Fannie and Freddie. But, rather, it's a risk that investors in turn bear because of any fiat in the regulatory process.

Senator **Cranston**. I think this logically leads us to——

Senator **D'Amato**. Alan.

Senator **Cranston**. Yes?

OPENING REMARKS OF SENATOR D'AMATO

Senator **D'Amato**. I think the area, Mr. Chairman, of your examination is most important. Because I think we'd be doing ourselves a great disservice if we minimize the concern that exists in the public mind, and in the legislative mind as it relates to the soundness of the GSE's, in general. And I'm not talking about Fannie and Freddie and Sally, in particular, but all of their activities for a variety of reasons. And I think all of the people at this table are sophisticated, and understand that.

And it raises, in my mind, how it is that Treasury—and I asked a representative of Treasury—and I have not come to any conclusion; I simply don't know. It's hard to decipher the most appropriate way to monitor and regulate GSE's. And so when I see something that's put forth that let's find out if there'd be a triple A rating without their being a Government guarantee to rate it in that vein, I'd like to know if you can really carry out that kind of an assessment, and what do you really think the results would be?

MICHAEL BASHAM, DEPUTY ASSISTANT SECRETARY FOR FEDERAL FINANCE, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. **Basham**. Senator D'Amato, my name is Mike Basham. I'm the Deputy Assistant Secretary of Treasury. I run the Office of Federal Finance, and I was the Director of the Treasury Study.

In terms of the most appropriate way to regulate GSE's, I think one of the fundamental principles that we focused on was that these are unique entities.

Fannie Mae and Freddie Mac, even though they both serve the housing industry, operate in somewhat different manners. And I think, as opposed to trying to subject all of the GSE's, who do have different purposes, who are unique in the way they operate, unique in the markets that they serve, we felt, rather than subject them to sort of a unified regulator who would sit there and try to come up with an appropriate rule that would apply to all of them, somewhat similar to the bank and thrift industry, we felt, why not take a somewhat more sophisticated approach. These are private companies, after all. Why not use the private sector credit analysts, the people who are experts who have the knowledge and the expertise in all of these disparate fields, why not bring them into the equation and let them bring their expertise to bear.

We happen to think the GSE's, given the way they're structured, will benefit from a sophisticated analysis, as opposed to a somewhat unsophisticated analysis. I think the rating agencies, based on our conversations with them, are well equipped to come in and analyze these unique entities, do an effective job of analyzing what the potential risk exposure from their operations to the Federal Government is.

And in terms of how in fact they can accomplish this, suffice it to say, this was not something we pulled out of the air. We did have some rather detailed conversations with them, and this was something that two of the major credit agencies suggested to us would not be a problem.

Rather than get into the specifics of it, I'd rather, since their representatives are here today, I'd rather defer the specifics of how they would probably do that, to them. But we feel very confident they can do it. And we think while it's somewhat of a different approach. We think, quite frankly, the GSE's themselves, would benefit from this because they are unique entities, and a sophisticated analysis would only benefit them.

Senator **Cranston**. Well the agencies are here. Would they respond?

THOMAS GILLIS, MANAGING DIRECTOR, STANDARD & POOR'S CORP., NEW YORK, NY

Mr. **Gillis**. Yes, Senator.

I am Tom Gillis from Standard and Poor's Corporation.

Standard and Poor's feels fully capable of going in and analyzing the risks associated with the various enterprises, Freddie Mac and Fannie Mae included.

Senator **D'Amato**. Oh, OK.

Mr. **Gillis**. You know, we do currently analyze all the various business lines in other industries, such as the mortgage insurance industry and the savings and loan industry and banking industries, as well as the bond insurance financial guarantee industry. So we would tap on that expertise to determine what the proper credit rating of these entities would be for the Senate.

Ms. **Bernstein**. Mr. Gillis, would that be with or without all of their Federal attributes?

Mr. **Gillis**. What we feel that we are capable of doing is going in and analyzing the risk to the Government of Fannie Mae and Freddie Mac, as they are currently legislated.

Ms. **Bernstein**. With full Federal attributes, the ability to borrow, et cetera?

Mr. **Gillis**. That's correct.

Ms. **Bernstein**. That's very different from what the Treasury was suggesting, isn't it?

Mr. **Gillis**. That was not my understanding.

Ms. **Bernstein**. I thought the Treasury was suggesting an analysis without Federal attributes, which would be a very different thing.

Mr. **Basham**. I think, specifically, Carol, what we suggested was without the benefit of the implied guarantee. Of course, the Treasury Department doesn't admit there's an implied guarantee, and we know you, at Fannie Mae, don't admit there's an implied guarantee. But I think we both know the market feels there is one; they don't believe either one of us.

In point of fact, the implied guarantee is not useful to the Government because, how does the Government, in essence, insure itself. I think the way we envision this, you have a methodology, you have a way of operating. Obviously, the types of mortgages, whether you retain them or securitize them, all of these things have some bearing on potential exposure to the Government. And we got the distinct impression from all of the credit rating agencies, it wasn't just two, it was three or four of them, actually, that we chatted with, that this was something they could do without any difficulty at all. So, we said without benefit of the implied guarantee. That doesn't mean the special links, which are statutory links embedded in your charter acts would disappear, because we all know they would still remain.

Senator **Cranston**. Maybe we should move on to the next phase of suggested questions, if you'll look at them, relating to HUD and oversight.

Congress placed oversight of Fannie Mae and Freddie Mac in HUD because of the essential role these corporations play in national housing policy. HUD is charged with ensuring that Fannie Mae and Freddie Mac serve the public purpose and don't create unreasonable risk. Some argue that HUD is not up to that task. They contend that HUD doesn't have the expertise to regulate Fannie Mae and Freddie Mac effectively. Some suggest that there may be a conflict of interest if one department is responsible for relating both the program and the financial soundness of government-sponsored corporations. They would place responsibility for oversight in a separate agency.

HUD testifies that it is capable of regulating Fannie Mae and Freddie Mac. They point out that they plan to, No. 1, fully incorporate regulatory responsibilities into its management structure, No. 2, establish a financial institution unit within HUD, No. 3, develop financial models to analyze risks and capital standards.

So compressing the questions a little bit, let me pose the following for discussion:

How do you assess the capacity of HUD to engage in effective oversight? Is it possible, in practice, to insulate regulation of the corporation's missions from regulation of their financial safety and soundness? Is it realistic to expect, No. 1, agency to regulate safety and soundness without having that agency oppose its own agenda on the public mission of Fannie Mae and Freddie Mac? No. 2, what regs to address the oversight will be most urgently needed soon? And, finally, how should capital standards for Fannie Mae and Freddie Mac be established and monitored, and what are the most important aspects of risks for these standards to assess?

Who wants to wade into that?

Mr. **Brendsel**. Mr. Chairman, maybe I'll take a crack at it to start out with, since Freddie Mac, as I said before, just came under the oversight of HUD. I've been impressed with their approach to establishing effect regulation of oversight in Freddie Mac. In fact, the work is ongoing to put that in place.

I'd also say, with regard to the previous discussion about rating agencies, while I think rating agencies do sophisticated analyses on a variety of risks that we are engaged in, I also think that HUD, with their staff, can do equally sophisticated and possibly more sophisticated analysis of us. In any case, they certainly can rely on some information provided by rating agencies to form their own judgments.

I think the benefit of having HUD as a regulator, and in fact, having both safety and soundness and the mission under the regulation of the same entity, is that in fact Government charter corporations, like Fannie Mae and Freddie Mac, are very unique entities, as has already been said eloquently by a number of witnesses here today. There is a balance. There is our mission that we need to fulfill. At the same time, we need to do it while operating in a safe and sound manner at little or no risk to the taxpayer.

But ultimately, matters about how much capital to hold, how much risk that these companies should take, are matters of judgment, and I think it is judgment that requires knowledge both of the mission, as well as safety and soundness. And in fact that's the benefit of having it all embodied within the Department of Housing and Urban Development.

Senator **Cranston**. Yes?

Mr. **Seiders**. The question of regulation and oversight is certainly not just a technical issue, like, who can do it best or who can do it all right. I think your question posed on the sheet about the potential of Treasury imposing its own agenda, viz a viz, Fannie and Freddie's purpose and role in the world, is a serious matter.

I worked with President Reagan's Housing Commission in the early 1980's, directing the staff work on finance. At that time, it was awfully clear that the feeling from OMB and Treasury was that Fannie and Freddie and other parts of the federally supported housing finance system were sort of directing too much capital into housing, that they needed to be constrained and reined in.

One of my concerns right now is that OMB and Treasury are taking sort of advantage of the current panic situation caused by the thrift problem to sort of continue this, what has been almost an ongoing assault on Fannie and Freddie since the early 1980's. You mentioned, in your opening remarks, the question of the ideology of OMB throughout the Reagan administration.

So I think the question of Treasury or some agency, other than HUD, having the responsibility for the financial oversight could in fact undermine the program or purpose of Fannie and Freddie.

Ms. **Bernstein**. Mr. Chairman, Fannie Mae subscribes to the principle of having adequate capital and appropriate oversight. We believe that capital standards can best be set by applying risk tests, stress tests, and covering with capital the risks that are actually posed by each of the entities. As such, we have put on the table a proposal.

We believe that it is up to the Government to decide how the regulation should be effected. If you believe, after due consideration, that there should be separate safety and soundness regulation from program regulation, we believe it'll take a great deal of thought and work and direction as to how the various aspects of the problems are then reconciled. To what degree does the safety and soundness regulator have the ability to come in and just stop everything? To what degree is program important?

We believe that these are very serious and complex issues that need due deliberation and that should not be treated quickly as an emergency program in a budget summit fix, as has been proposed by Treasury. We believe that the Government, itself, is able to do the supervision that's necessary.

I should say that, in this past year, we have not been unsupervised. Treasury and GAO representatives have been virtually living at Freddie Mac for a number of months. And I think we expect them back next year. I think Fannie Mae has had the same experience.

I believe we have heard from Mr. Gillis that S&P can evaluate Fannie Mae and Freddie Mac as they are. We can quibble about what does it mean to evaluate us without the Government's implicit guarantee. I don't know what that means in terms of access to markets, to borrow, etc. I wonder what Moody's would say about its ability to deal with what I think are hypotheticals.

Mr. GILLIS. If I could? I'm afraid I might have been misunderstood. We're not saying that we could assess the credit strength of Fannie Mae or Freddie Mac if they were to be privatized tomorrow or cut off from their links to the Government. What we do feel comfortable in assessing is the risk to the Government or the probability that the Government will have to come in and support the entities.

Ms. BERNSTEIN. So that's different from the Treasury proposal. That is just, you could assess us as we are now?

Mr. GILLIS. My understanding of the Treasury proposal, again, is that the risk to the Government that these agencies pose.

Senator CRANSTON. Yes, Mr. Stanton.

Mr. STANTON. I guess some history is useful here. And, Senator, you played a large role in this.

HUD tried to promulgate regulations in the late 1970's to get Fannie Mae to dedicate more resources to low- and moderate-income housing. Fannie Mae marshalled a campaign, despite your best efforts, that destroyed that HUD initiative.

In 1981 through 1988, as Mr. Seiders has pointed out, HUD was part of a Reagan administration initiative attempting to look at privatization of the two entities, and again, those initiatives were successfully destroyed by Fannie Mae and Freddie Mac.

Freddie Mac, at the same time, was resisting a number of efforts of its own regulator, including the effort, in 1987, to limit REMIC issuances and actually to limit Freddie Mac's total issuance of securities in any given year. And Fannie Mae similarly fought HUD successfully, again, on the REMIC's issue.

What we see is a concerted effort, over about 15 years, of these two huge politically powerful institutions to pound their regulator into submission. And suddenly Fannie Mae and Freddie Mac turn around and ask HUD to rise from the sick bed and assert its sovereign authority to set capital standards.

One important reason to have the rating agencies go in and make an independent commercial judgment is that kind of politics is taken out of the process. Your point, consistently in this hearing, that we've got to make a legitimate tradeoff between the level of that rating and what it does to the housing market, is very important.

And one way to do it is make the tradeoff, I respectfully submit, is, for example, to go to a double A, which is probably very close to where Freddie Mac is today. That minimizes disruption to the housing market. That's a way to get at that balance issue, which is very important—and I agree completely—while, at the same time, trying to depoliticize, in the sense of hardball regulatory capture, the process of setting capital standards and, to some extent, assessing risk.

Mr. DELLIBOVI. Mr. Chairman, if I may.

We've sat here quietly because it's interesting to hear all of these comments. Let me begin back a little bit on the issue of examinations. I think Mr. Stanton makes a very legitimate point. Secretary Kemp, Dr. Weicher and I feel very strongly that there is a legitimate role for an examination process. And as part of our evolving responsibility—and I say, evolving; we've had the responsibility for Freddie Mac for a little less than 51 weeks. I can't attempt to defend the longer-than-51-week responsibility for Fannie Mae. I think we've done a good job with both of those responsibilities on Jack Kemp's watch. I think that's testified to by the high regard expressed both here and in our own hearing early this week on the two reports that HUD produced. I've heard the words, first class, highly professional, used by all persons across the spectrum, including Mr. Stanton.

Now, when it comes to using the ratings services, certainly there is a role, and they can be used with HUD. The key question is, what are the standards that they're going to apply. What are the assumptions they're going to be told to use. There's no question they're experts, they have the ability.

Then the question becomes, what does the regulator do with the report that it receives. And we understand that at HUD. So examinations will be part of our process. We may, and probably will use the rating services. We've been in touch with them. They've offered us technical assistance even if we determine not to engage them on a contractual basis.

Finally, I'd like to just touch on the issue of the bifurcated two-headed regulatory monster. We've had some experience concerning what got HUD to the sick bed and have seen what happens when two institutions are in charge. When two people are in charge, in my management experience, nobody's in charge. And I would submit to you that we would either rather be responsible for the entire operation or none of the operation. It's very difficult to manage half of the operation, as Ms. Bernstein pointed out very well. That's certainly our viewpoint. The potential for conflicts, finger pointing, blame pointing, when two agencies are given that kind of shared responsibility, creates a situation which is extremely difficult, and I believe unmanageable.

Mr. HARVEY. Mr. Chairman, if I may?

Several of the comments really lead us back to the historical context for Freddie and Fannie to have any special benefits with the Federal Government whatsoever. And that context is the context of national housing policy and their public purpose. And that properly resides, at least as last I knew, in the domain of HUD. I think that Mr. DelliBovi and Mr. Weicher are hardly sick at this point in time, and are very able and have been able to regulate well and to clean up well what was in HUD.

The historical context is very important because if you start to look outside to a rating agency measure, which is measuring primarily the safety of the organization and not the public policy that it was created to serve in the first place, I think you've missed the whole point. You've eliminated Freddie and Fannie from their public purpose role and the reason that they were set up to have these special benefits with the Federal Government.

And obviously they have to be sound. And obviously HUD can employ the measures that are being used by others on the outside, which I think is an art and not a science. I was once on Wall Street. The rating agencies are very good but there isn't any black box that you'd use. And certainly the way they judge and look at risk can be either purchased or carried out independently within HUD.

And then HUD has to make that balance and that tradeoff between the public policy and the capital adequacy. As you move towards triple A or some kind of rating of that sort, you lose a lot of the benefits. And particularly for us, who are interested in very low-income Americans and affording them proper housing, at some point, you lose the public purpose altogether. And obviously that tradeoff is critical. And I would subscribe that it cannot be housed in two places.

And to the extent that this agency carries out that public purpose, it should be that part of the Government that is looking over national housing policy.

Mr. **Basham**. Mr. Chairman, on the issue of, as Secretary DelliBovi called it, bifurcated regulation. Obviously, those of you who have read our study are familiar with the guiding principles. One of those guiding principles is that the regulator of safety and soundness should be separate from the regulator of the program.

This was one of the guiding principles that's been incorporated into administration proposals for GSE safety and soundness that clearly have been discussed as part of credit reform in the context of the budget summit. We think that it is difficult for someone who is responsible for seeing a program succeed to suddenly switch hats and have to make the tough decisions on safety and soundness at the same time. We think there's a potential for some inherent conflict there.

As far as the issue of whether triple A, itself, is too high a standard, based on our analysis and some informal conversations we've had with the rating agencies, we feel there are probably three of the GSE's that are already triple A; most specifically, Connie Lee is already publicly rated triple A exclusive of any Government support by Standard and Poor's. We think there's a strong likelihood that both Sallie Mae and the Federal Home Loan Bank system are already rated triple A, as well.

And it would seem to me that if we have three GSE's that are in a position to serve their public purpose efficiently and effectively, with minimal exposure to the taxpayer, it's not too much to ask that the other GSE's aspire to the same level. As a matter of fact, we probably would be sending the wrong message to those GSE's that are triple A if we somehow encouraged them to take more risk and expose the taxpayer to potentially some loss down the road.

Senator **Cranston**. On the specific matter of capital standards for Fannie and Freddie, how should they be established and how should they be monitored?

Anybody have any comments?

Mr. **Brendsel**. Mr. Chairman, I think with regard to regulating safety and soundness of Fannie Mae and Freddie Mac, I think there are three key ingredients to that, three parts of it. One is establishing adequate capital requirements. Second, providing meaningful and timely reporting that monitors the financial condition. And the third is to have appropriate enforcement authority to ensure that safety and soundness is maintained.

With regard to the first of establishing adequate capital standards, certainly these must be sufficient to make the threat of failure remote. I think it's often overlooked the fact that in order for us to accomplish our mission, we should be safe and sound. And I think everyone is really speaking to that here at this table.

But exactly how much capital should be required is really a matter of judgment, balancing the needs to support the mortgage market against the risks. And certainly the risks and the capital requirements should be related and linked in some way, such as through stress tests analyses, that have been talked about here today.

I think HUD, as reflected in their annual report, is on the right track towards, first of all, assessing those risks, and second, establishing how much capital is appropriate. And I trust they will, in balancing these competing objectives of the mission against safety and soundness for the taxpayer.

With regard to adequate, meaningful and timely reporting, this is the second key ingredient. Certainly, there's a lot of reporting that both Government chartered corporations provide, and HUD has recommended market value information as well as information on the characteristics of the mortgages that we are purchasing. This is exactly what is needed, and in fact, we are already providing that kind of information to HUD today.

Finally, with regard to enforcement authority, formal regulatory system that Freddie Mac has with HUD, provides the Government and HUD not only with effective early warnings of any problems, but with sufficient authority to step in and prevent any actions that they believe might be harmful to our safety and soundness.

Mr. **Campbell**. Senator Cranston had to step out for just a couple of moments. But, does anybody else have a comment on this question?

Yes, Mr. Oliva.

BILL OLIVA, MANAGING DIRECTOR, SALOMON BROS., NEW YORK, NY

Mr. **Oliva**. I'm Bill Oliva with Salomon Brothers, the investment banking firm.

I think in looking at a discussion of capital, let's not just kid ourselves and say that capital is the be all and end all. Clearly, it's very, very important in maintaining the safety and soundness of any institution. It's obviously the last line of defense, if you will, against significant problems.

But there are lots of controls already in place, and there are lots of other items that one needs to look at in assessing an institution's safety and soundness, and they need to be viewed as a package.

First, in the case of both Fannie Mae and Freddie Mac, each is limited by its charter. They're in a single business. They're in the business of providing a secondary market in permanent residential mortgages.

Second, their underwriting standards and documentation are public. There's some room for adjustment but only where additional protection is provided, and as there are changes in the mortgage market and adjustment is necessary for them to go forth with their public policy initiatives.

Third, HUD has been the regulator for Fannie Mae for a number of years. There are congressional oversight committees that are in place. But I think maybe most important is looking at the management teams which was referred to earlier, in fact, by Mr. Stanton. One of the key considerations in the safety and soundness of an institution is its management team. And if you take a look at the record of both Fannie Mae and Freddie Mac, I think you'll see that the management teams there are superior. Look what's happened over time.

Freddie Mac, during a time of terrific growth in the mortgage market, has consistently maintained a small balance sheet relative to its operation; has consistently funded off balance sheet, eliminating interest rate risk. That is a specific management decision.

Fannie Mae, back at the end of 1981, began its mortgage backed securities program, after it had some problems, in order also to mitigate its interest rate risks. We've seen delinquency and loss experience on the part of Freddie Mac which is considerably below the national average. Fannie Mae's delinquency and loss experience has been coming down over time.

Both institutions have made a significant effort in asset liability management. Fannie Mae, as was referenced earlier, is a lot more thoughtful in the issuance of debentures to fund its portfolio.

So I think, while certainly we need to look at capital, we need to look at other aspects of the institutions, and look at the institutions on a total basis, not merely the capital ratios.

Mr. BASHAM. I would agree with Mr. Oliva. And that's one of the reasons we like our rating agency approach so much. It's not just a function of capital. Some people have said that the GSE's, specifically Fannie and Freddie, need one of two things: either a tremendous amount of capital or a tremendous amount of oversight. And I think some of the proposals embodied in our report acknowledge that too much capital would probably impair the ability of any GSE to serve its public purpose as intended by Congress.

And at the same time, we are, after all, Republicans. I don't think we're big on a tremendous amount of regulation at the Treasury Department. In terms of what this means for GSE's, our approach can, as Mr. Oliva said, take into consideration that the management teams are important. I think the rating agencies are in a position to factor these things into their analysis.

If it were simply a function of capital, you're going to require, if you want to ignore management teams, if you want to ignore informational systems and how good they are or aren't, if you want to ignore duration mismatches and retained portfolios, if you want to ignore all of these things and be assured of safety and soundness, it will take too much capital and it will begin to impact the programs of these GSE's. And that's not what we're about.

What we're about is coming up with an appropriate level of capital that will protect the taxpayer from any potential loss and at the same time it is important to us that all of the public purpose beneficiaries continue to receive the benefits that Congress had intended for them to receive without any diminution in service or increase in price. And we think using a rating agency which can come up with an appropriate level of capital, that takes into consideration all of the things that have a bearing on risk, goes a long way toward doing that.

Ms. **Bernstein**. Mr. Campbell, the rating agencies are wonderful at doing what they do, which is studying businesses and evaluating long term senior debt, by and large. They have no experience in setting standards for people. They evaluate and say, yes, we believe X debt will be paid with a great degree of surety.

The Treasury proposal offers no reason for suggesting a triple A standard, other than any other standard, except that it's the highest and the best. There is no evidence that is the most appropriate standard in terms of providing any security to the Government.

Ms. Berger spoke eloquently about the shareholders and their investment and what they respond to. The shareholders will lose every penny that they have invested before the Government invests its first penny. I think that's important.

At the risk of being repetitive, I would like to point out that in the proposal that Treasury Staff put before the Working Group of the Budget Summit, they talked both in terms of getting a triple A rating, each of the GSE's within three months. I have to say that, as far as I know, neither Moody's nor Standard and Poors has said what its absolute standards are for triple A. So that I'm unable to tell you what it would mean in capital and other things for Fannie Mae to get a triple A.

The Treasury's words are, "the rating paid for by the GSE must be made without regard to any implicit or explicit Federal guarantee or other benefit." To me, that means you take away the agency's ability to borrow, sell MBS, etc., because that's what the Federal benefit is. It is taking an entity and making a hypothetical entity out of it, and saying, rate that. This is not really a responsible proposal. If the agencies don't get the triple A, whatever that is, they then must submit a business plan to Treasury. Treasury has said that we should give this power to the rating agencies because the Government can't decide what's appropriate capital. Then it says that Treasury will approve the business plans. And if Treasury doesn't like the business plan submitted by a GSE, Treasury will write its own business plan.

This is the kind of economic and political risk that our PSA Goldman Sachs representative was talking about as the real risk posed in the marketplace at this point. This is not a responsible suggestion. There clearly are appropriate regulatory and capital approaches that should be taken. But the Treasury's quick simple fix is a dangerous one, and should not be done.

Ms. **Berger**. Mr. Campbell.

Mr. **Campbell**. Yes?

Ms. **Berger**. I'd just like to add to that I agree with what Carol said. But to go further than that, I don't think the Treasury proposal is even practical. There are thousands of commercial banks in the United States and not one bank-holding company has a triple A rating by two of the major rating agencies. I think it's completely inappropriate and impractical to require your GSE's to come to a standard that nobody in the private sector has.

The GSE's were chartered by Congress to fill voids in the financial system that private enterprise couldn't or wouldn't fill on a cost effective basis to their constituencies. You have to revisit not only the missions that these agencies were chartered to, but you really have to look at the cost of those agencies (or the potential cost) of these GSE's versus their benefits. There is no part of the Treasury proposal which talks about these benefits.

They choose what I think is an arbitrary standard. I mean, triple A is inarguably the highest standard. You know, if there was a quadruple A, they might have chosen quadruple A. But it's the highest standard, clearly inarguably the highest. But there was nothing in their study and nothing in their proposals that spoke to the benefits. It gets back to the question of risk reward. How much risk is the Government at versus how much benefit do they provide to their constituencies. And until you know that it would be imprudent to change them—it would be like building a dam without an environmental impact study. Until you know what those benefits are and until you know what the potential costs are, I don't know how you change them or regulate them further.

And I have a lot of other questions for Treasury, including the fact that in their proposals, they could not define adequate capital. And therefore abrogated this responsibility and would throw it over to the private sector rating agencies to do so. However they do feel that they could come up with the business plans for these agencies if they do not meet triple A rating. I find tremendous inconsistencies in those statements. They don't know what adequate capital is, and yet they could fix it if it was inadequate.

Mr. CAMPBELL. We haven't heard from Moody's yet. Mr. Kriz, would you like to say something at this point?

Mr. BASHAM. Mr. Campbell, if I could just interject one comment here.

Both Fannie Mae and Freddie Mac went to a great deal of time and effort to persuade the Treasury Department and GAO that risk-based capital standards for banks and thrifts were not appropriate. I can't speak for the Secretary, I'll speak for myself right now, if Fannie and Freddie would both agree to subject themselves put to the same level of regulation that banks have, as well as to risk-based capital standards for banks, we might be willing to forego our triple A requirement and just leave it at that. I think that would provide an adequate level of safety and soundness for this whole process. And, by the way, we agreed with them; they are not like banks and we don't feel their capital rules are appropriate. But I think, if they would agree to subject themselves to that level of regulation that banks have, as well as the same capital standards, then we might forego the triple A; we might forego our whole plan. That's me speaking, of course; that's not the Secretary.

Mr. CAMPBELL. We haven't heard from Moody's, yet, and I'd like to make sure that Mr. Kriz has a chance to contribute at this point.

JOHN KRIZ, VICE PRESIDENT, MOODY'S INVESTORS SERVICE, NEW YORK, NY

Mr. KRIZ. We've been asked a couple questions. I'll do my best to take them in turn.

One was, as I understood it, the ability of Moody's to assign the type of rating that we believe we've come to understand the proposal implies. The conclusions that are drawn could be potentially heavily affected by the assumptions that are made at the beginning of the exercise. We would not want to find ourselves put into the potentially awkward position of making arbitrary assumptions if these assumptions end up being important to the conclusions that are drawn. So, yes, we can draw these conclusions, but there may be a need for considerable clarification on what type of appropriate assumptions should be made at the beginning of the exercise.

We were also asked regarding advising firms on achieving a certain level of credit quality. The focus of Moody's has always been on assessing default risk, rather than advising a company on a particular course of action. In the structured finance area, however, we do have published standards on reaching a certain level of credit quality for let's say a double A passthrough security or a triple A rated mortgage-backed bond. But for these types of transactions, the rules are very very finely circumscribed and stated. This is often not the case in a going concern analysis, as is the case for a living, breathing corporation that changes over time, has now management, new business opportunities and so forth.

And we believe that the use of a structured financing type of analysis—a very directed analysis—may lead potentially to inappropriate conclusions when used to analyze a going concern. And we have been reluctant to take on that advisory responsibility because the potential it could move us towards assuming the role of being a regulator or a consultant, as opposed to being a very independent source of credit analysis.

There was also a question on business plans, as I understood it. And again, I would reference my remarks on acting as a consultant. There is also potentially the issue of a good plan, but the ability to execute against the plan may be something else. In addition, it's often difficult, we believe, to again act as an adviser perhaps in construction of a business plan, due to the great challenges and complexity of doing so.

Mr. **Campbell**. Thank you.

PETER J. BLAMPIED, PRESIDENT AND CHIEF EXECUTIVE OFFICER, BOSTON FIVE CENT SAVINGS BANK, BOSTON, MA

Mr. **Blampied**. Mr. Chairman, if a business plan contains a large portion of housing programs, affordable housing programs, how would you deal with that? Does the portfolio have an inherent risk factor, based on a concentration in certain types of loans? How does that get factored in. Maybe talking about current or past securities could shed light on that.

Mr. **Basham**. If I could, for a second. On the issue of low-income housing, I happen to agree with Mr. Harvey and Mr. Hunt. By definition, support for low-income housing does not have to be risky. I don't see where an effective program to support low-income housing has to present an undue concern for a Fannie or Freddie. I think any of these programs can be structured to keep the risks low. I think the statutes allow both Fannie and Freddie to participate and encourage them to participate in support for low-income housing, with the caveat that they are allowed a reasonable economic return. I note that some initial analysis on our part suggested that the low-income housing program was a fairly small percentage of their business. It is meaningful in terms of its size, but in terms of the size of Fannie and Freddie, they are fairly small portions of the overall business. And I don't see where this would have to present an undue level of risk that the rating agency, itself, would have to be concerned about.

More importantly, as I understand the way some of the programs work, the Community Lending Program, Fannie will, for instance, take a first mortgage, but there can be some assistance from a local housing agency that will provide in essence a second mortgage at possibly a preferential rate so that in essence Fannie and Freddie would end up having a low-income mortgage that would in effect meet their own underwriting standards.

So I would agree with Mr. Harvey and Mr. Hunt, by definition, low-income housing does not have to be risky. And I think that's an important part of both of their programs, and I don't see where our proposal presents any threat at all to low-income housing in the United States.

Mr. **Harvey**. Mr. Chairman, may I answer that——

Mr. **Campbell**. Yes.

Mr. **Harvey** [continuing]. With a concern of our own. I believe the average size of the Fannie conventional one- to four-family mortgage is 80,000, and yet 20 percent of that, I believe, is below $40,000, so there's a large segment in their conventional business that serves low- and moderate-income Americans.

One of our concerns is that certainly higher down payment loans are judged less risky than low down payment loans are. And as you move towards the criteria of attaining one of the highest ratings in the country for any business enterprise, which is the triple A that you have presented, I think that Fannie and Freddie would react rationally, particularly if they felt they had to achieve that level in a very short period of time, to be very conservative as to how they underwrite, and to cater to whatever the private sector's perception is of loans. And obviously, if there can be a larger down payment, they'll get farther down that road towards a triple A, without anyone knowing what the absolute standards are. But certainly, a more conservatively written loan is going to get you there faster.

And, as you tilt the whole program towards achieving a triple A or achieving the soundness, you've lost your public purpose along the way. And you've lost the total balance in your program. And, as I understood the proposals that were put forth, there's some very serious consequences if they don't move along that line and very quickly.

And there is no objective standard for us to go back to them on, us who want them to serve the public purpose part, for us to come back and object to them. Because they'd have to say, I've got to meet this ultimate standard of capital safety, and if I don't, it affects all of our operations. And, therefore, we fear, at least speaking for the Enterprise Foundation, that the public purpose gets lost in that. And that's the reason they're in being. At some point, they——

Mr. **Basham**. I would agree with you, Mr. Harvey. Quite frankly, there are private mortgage insurers, private entities that will securitize our pools of mortgages but they do charge a higher rate. I think one of the rationales for the existence of Fannie Mae and Freddie

Mac is they are able to do it cheaper than a private sector company. Believe me, it's not the intention of our program at all that they have to raise either the guarantee fee or reduce the level of service to any of the pariticipants in their programs.

I don't think it's appropriate to say that because somebody has to achieve some higher level of safety and soundness, this is going to mean some immediate curtailment in all their programs. What we're proposing is a 5-year phase-in. Quite literally, what we're proposing is to have the rating agencies do a rating. I think, clearly, neither Fannie or Freddie are triple A now. There would be some areas where they're deficient. It's not just a function of capital. Clearly, if you securitize more, retain less, that lowers the potential risk exposure and would entail less capital.

Again, I think in terms of the overall level or exposure of the low-income housing program, and I still agree with you that it doesn't have to be risky. As I understand the way they're done now, they're not risky. And I personally wouldn't see where that would present a problem, given the size of these institutions.

I believe there was an ad in the paper recently where Fannie or Freddie—I forget which one, it wasn't steady Freddie, it must have been Fannie Mae—said that they had 80,000 low-income loans. And of course, they have, I'll say, over six million loans. So I think that's a significant contribution to the low-income housing in America, but, in terms of the potential risk that it might expose Fannie or Freddie to, it's fairly small.

I'll give you another example. In terms of Freddie Mac, one of the things that did concern us somewhat was the possibility of a duration mismatch in their retained portfolio. But to the extent that their retained portfolio is such a small portion of their overall business, we decided it wasn't anything to be concerned about.

So I would draw that same analogy with the low-income housing programs. And I feel that, again, the way you've described them and the way Mr. Hunt's described them, and the way I understand that they work, there doesn't have to be any diminution in those programs at all. And it's not our intention. And we think the proposal, the way we have it structured, would allow these entities to achieve a level of safety and soundness in a steady fashion over a number of years, without any diminution in service to any of the programs that they're currently serving.

Mr. **Harvey**. Part of what I'm talking about is their conventional business, their conventional single family business which helps many many moderate and low-income people across the country. Who do we answer to if all of a sudden the down payment goes up to get them to achieve—triple A—who is answerable to the public comments if Moody's and Standard and Poor's is——

Mr. **Basham**. I guess I would pose the same question to you. As I understand it, back in 1985 and 1986, both Fannie and Freddie tightened up their underwriting standards significantly, of their own volition. I know Treasury never forced them to do it. I think it was a business decision they made on their own. And I can't help but think that somehow that had some impact on the mortgage market and the availability of loans.

Now, I don't know who they answered to at that time. Maybe they answered to their program regulator. I don't know. But, again, they can take actions of their own volition, exclusive of our proposal, that could conceivably have an impact on the conventional mortgage market and have had in the past. I assume it was to reduce their exposure. I know Fannie, in particular, had had some significant credit problems in the early 1980's. And I think this was an effort on their part to try to reduce the potential risk to themselves, quite frankly, and I think that was a prudent and appropriate move. But of course it did have some impact on the market. But I don't know who they answered to at that time, and I guess I would pose the same question.

Ms. DOLBEARE. If I could inject here on this point a minute? I think it gets back to the question I raised earlier about the importance of HUD looking at the public purpose as well as the financial soundness. And I think if, in 1985 or at any time in the future, the standards were tightened to the point where it seriously impinged on that mandate, that HUD would have the responsibility for saying, wait a minute, maybe you're going too far.

I, too, am concerned about the impact of these proposals on Fannie Mae's lending in the conventional market. There's a chart, for those of you who have my statement, at the end of my statement, I did a kind of a very simplistic analysis of the Federal Budget as proposed back in January, using both outlays and tax expenditures. About $100 billion overall for fiscal years 1990–1991. Eighty percent of that is tax expenditures; $46 billion of that is the estimated cost to the Treasury of the homeowner mortgage interest deduction. And I would suggest that one of the things maybe we should look at is the interplay of tightened regulations or higher standards on Fannie Mae and Freddie Mac. If that results in higher mortgage interest, you might help the Treasury on the one hand, but if the impact is to raise interest rates, that causes a diminution in Treasury income on the other hand. So it may be self-defeating, even though it's in two different parts of the Federal budget.

The other point that I'd make is that, while low-income people get a relatively small proportion, the lowest quintal gets 13 percent of all Federal subsidies, the three middle quintals, the quintals that are served by these conventional programs, get only 25 percent of Federal subsidies. And if you look at the need for Federal assistance, it seems to me you can make a very good argument for saying, this is an area where the Federal Government, to the extent that it's necessary to provide people with an opportunity to get decent housing, needs to be more active. And that one of the most cost-effective ways of being more active is through the kind of Government-sponsored entity that we have in Fannie Mae and Freddie Mac.

And I just want to underscore that I think that that is a public objective which ought to be kept in mind, along with these other requirements of capital soundness.

Mr. CAMPBELL. Mr. Oliva?

Mr. OLIVA. Yes, thank you, Mr. Chairman.

I'd just like to respond to Mr. Basham's comments before, concerning the Treasury proposal and its impact on the current operations of Fannie Mae and Freddie Mac. I mean, if you look at the proposal in its entirety, rather than piecement we start out first with getting a triple A without regards to "implicit or explicit Federal guarantees." So we have a hypothetical rating.

I'd like to ask a little later, Moody's and Standard & Poor's representatives, how many hypothetical ratings they publish. [Laughter.]

Second, and perhaps more importantly, irrespective of the value or lack thereof of hypothetical ratings, it, at a point down the road, provides the ability for Treasury to reduce market access of Fannie Mae and Freddie Mac. Now, that's a very very serious statement there. As a matter of fact, when the Treasury proposal first came out, we got lots of phone calls from investors concerned about the proposal, what the proposal meant. Even if we're talking about 5 years down the road, there's a possibility 5 years down the road that some of these indicia of Government ties, I think mentioned were SEC registration, ability to be held by national banks and so forth, very very critical legal investment criteria could be cut off. That could impact today the trading levels and issuance levels of Fannie Mae and Freddie Mac securities, even if they don't ultimately go into effect 5 years down the road, if, in fact, this particular proposal is entertained—and, hopefully, it wouldn't be passed—but if it were passed. And I think that we need to look very seriously at what the implications of this proposal is today.

And I'd like to get Mr. Hinkle's response on the marketability. But I would suspect that if this were passed, it certainly could cause severe problems among a number of investors in the marketplace for both the mortgage backed securities, as well as the debentures. I think one thing to realize, the statement is made in here that that would merely put Fannie Mae and Freddie Mac on the footing with other private corporations. Because of their public nature and the public policy set in this country with respect to housing, Fannie Mae and Freddie Mac issue far more securities than any private corporation in the marketplace. Therefore, these legal investment criteria are critically important for them to obtain funding at the lowest possible cost, thereby providing homeowners with the lowest possible cost of funding. So it's not merely an issue of credit. It goes far beyond that.

So I would suggest that this Treasury proposal could severely impact the ability of the two housing agencies, Fannie Mae and Freddie Mac, to raise cost-effective funds today.

Mr. BASHAM. Mr. Chairman, if I could respond.

First of all, in terms of a hypothetical rating, as I understand it, again, this was not something that we just pulled out of the air. We had some significant discussions with a number of the rating agencies. Clearly, I think we would have been remiss if we had just decided, this sounds like a good idea, let's do it. We had numerous discussions with them. They all assured us this was not a problem.

I think one of the analogies that one of the agencies drew for us, is that quite often they are asked to assess the risk of wholly-owned subsidiaries of large corporations that operate and borrow money from commercial banks with a parental guarantee. They are asked to go in. It's not a publicly-traded company. They're able to borrow at preferential rates with a guarantee from the parent company that's got a much stronger balance sheet. And the parent company will come to them and ask them, assess the exposure that they have to the operations of this wholly-owned subsidiary. And I thought that was a very appropriate analogy.

So I wouldn't exactly suggest that this was hypothetical at all. This is something that's been done in the past.

In terms of reducing market access, clearly, if you read through Under Secretary Glauber's statement of last Thursday, we have refined the guiding principles that form the basis of the study and suggested that all outstanding securities would continue to retain all of the unique and special ties that they currently have. In other words, if I'd purchased a Fannie Mae subordinated debenture, the status of that debenture remains unchanged. It has all of the special ties and unique attributes that lead me to believe that there's an implied guarantee associated with it. All we've done is call into question the possibility that years from now, if this particular GSE does not have a triple A rating, we're not going to prohibit them from issuing debt, we're just going to suggest, fine, let's put the debt they issue now on the same footing with other private corporation debt.

They would lose some of the special ties that accrue to their securities that would in fact suggest that there was no implied guarantee, and that's the intent of the proposal. But that's 5 years down the road.

I might draw another analogy from the banking code. The banking examiners are in a position to withdraw deposit insurance from any institution with just cause. Some people would refer to that as the thermonuclear war concept. That's rarely if ever used. I would suggest, as well, that as draconian as losing some special attributes might be in 5 years, it's one of those things that both the safety and soundness regulator, whether it's Treasury or someone else, as well as the individual GSE's, would make sure didn't happen.

Mr. **Hinkle**. Mr. Chairman, if I might respond from the capital markets point of view.

I think, in fairness, Treasury, in its proposal, has done everything it can to structure a mechanism to achieve safety and soundness which tries to protect current investors in the secondary capital markets for mortgages. However, no matter what they do to structure that proposal, it may not be possible to give the markets enough confidence so, that at the end of a 5-year phase-in, investors continue to be willing to wait to see what happens.

The logical question that will be asked by investors is—and this is intended to be a respectful statement of Treasury but to bring a market viewpoint into it, if the agency is not in compliance with the triple A mandate, my securities began implicitly supported by the Federal Government in some ways, does that mean, at the end of 5 years, if I have a security that matures after that deadline, the Federal Government is explicitly at that point the guarantor of that security? That's the question I believe the capital markets will ask. And, unfortunately, it may not be possible to insulate Fannie Mae and Freddie Mac from the response of the capital markets, because we do not know now if, in 5 years, the Federal Government will say, yes, you were explicitly guaranteed on the securities you owned 5 years ago.

Mr. **Brendsel**. I've had a number of discussions with Mr. Basham about his proposal over time. And while I respect the quality of the work that the Treasury Department did on the analysis of both Fannie Mae and Freddie Mac, it appears that when they got to their recommendations, it bore little resemblance, if any, to the quality of the analysis and the study of the risks of the two corporations.

The Treasury proposal is just one of many that could have been made. In fact, it was a proposal that's already been described as a very extreme proposal that shifted, I think, the regulation over safety and soundness way over to extreme, that I think would do major harm to the secondary market and to the companies with little benefit, as a result, really no benefit as a result.

Overall, I'd just like to say this: that the success of the secondary mortgage market, as it exists today, and it's well documented what it's been able to accomplish in the 1980's and as attested to by Mr. Greenspan and others, has been achieved as a result of building on the confidence of investors and stockholders, private individuals that are willing to put up their money to invest in mortgage-backed securities and other obligations issued by these companies, and stockholders willing to put up their money and place it at risk. Over this time, it clearly has resulted in maintaining the flow of mortgage money to housing at lower rates and greater availability in communities across the country. And we've done it in a safe and sound way that has been attested to here today.

Mr. Basham raised the question, earlier, you know, what led Fannie Mae and Freddie Mac to change their underwriting requirements back in 1985 or 1986. Were they forced to or did they choose to do it out of their own responsibility towards achieving their mission, including being safe and sound. The fact of the matter is, with regard to Freddie Mac, it was the latter. In order for us to achieve our mission, we have to maintain the confidence of investors and stockholders, which means we have to adjust underwriting guidelines, any number of things, over time.

That doesn't mean that I'm not saying that appropriate regulatory oversight shouldn't be provided, as well, and I've made some comments on that earlier here today as to how that can be provided. But I think it should be built on really recognizing that these corporations have a responsibility, themselves, much less being forced into it by regulators.

The final point I'd only make here is that, how much capital we should maintain I think is a matter of judgment, that really has to be conditioned based on the risks that we take, the interest rate risk and credit risk, and others. I frankly believe, and I've spent a lot of time on this trying to understand Freddie Mac risks over time, and I frankly believe that we're very well capitalized. In fact, we're far better capitalized than the private banking industry today on balance. But I think it's been achieved through operating with a very well-defined mission in the residential mortgage market, where the greatest quality of credit is provided, someone's home backing up that mortgage.

In addition, we've done it operating in ways that a purely private firm would not. Yes, I agree that low-income programs need not be more risky. And in fact, I don't believe they are, if done in the right way. At the same time, there are important differences in how we operate from purely private firms. They relate to such things as, for example, never withdrawing from markets, staying in Texas throughout the 1980's when other private firms were pulling out. It is a responsibility that we have in order to achieve our mission and, as a result, I think we are able to achieve that without posing any risks to the taxpayer.

Mr. **Campbell**. Mr. Stanton.

Mr. **Stanton**. We have a need for safety and soundness and we just can't be satisfied with mere incantations about the need for these institutions to help housing. After the Savings and Loan debacle, I frankly wish I had paid a little more for my mortgage. Remember that Savings and Loans had a housing mission too.

So we've got to be careful, on the one hand, to balance safety and soundness against a legitimate housing mission on the other.

I respectfully suggest, in the 1987 HUD report on Fannie Mae, there was reference to the 1986 Freddie Mac Task Force report, indicating that Freddie Mac is probably close to a double A. I believe that housing concerns on both the conventional side and the low- and moderate-income side have to be addressed. If Freddie Mac is close to a double A and doesn't have much of a reach to get there, then in fact we can minimize adverse consequences to the housing market from imposing that standard with a generous transition period of 5 years.

And proposed Treasury business plan the sanctions, are the same thing you do with banks. You say, OK, here's the capital standard, and then specify numerous enforcement powers, to be used only against the very worst actors, and I don't believe we have the worst actors here.

So my contention would be that, on the one hand, a double A rating—to modify the Treasury's proposal—would be a legitimate way for this committee and for the Congress to say, OK, we are now trading off, and we're going to keep monitoring this issue and watch the real world effects, and then we can adjust up or down as the case may be to do further balancing. But that's a congressional decision, not a HUD or administrative decision.

The second issue involves low- and moderate-income housing, Cushing Dolbeare's legitimate concern. We have a useful model in the Federal Home Loan Banks. The Home Loan Banks are told, you will set aside *x* amount of money and you will buy down interest rates. That's a contained amount of money, that doesn't expose the institution to an exorbitant amount of risk. And you can negotiate over the level of money. But it allows the banks to help lower income people than can be helped simply with conventional mortgages.

I respectfully suggest that might be a model that we want to apply to Fannie Mae and Freddie Mac as well.

Senator **Cranston**. I think we're coming to a time when we should try to draw this to a close, but does anyone have any other comments on the safety and soundness issue, the ways we're getting early warnings or whatever?

Ms. **Bernstein**. Mr. Chairman, Mr. Basham asked whether Fannie Mae and Freddie Mac would be willing to subscribe to the bank and thrift standards, and said he would pack his bags and go home if we said, yes. Essentially, I think we need to deal with that.

That's a standard that Treasury, GAO, and everybody else agree is not appropriate for Fannie Mae and Freddie Mac, and I would like to say on the record that I hope he wasn't serious in making his statement. I think he was being flip. But I think we should go on the record as saying that we do not think that's appropriate. We don't think triple A is appropriate. We think that there is a standard that is appropriate, and with due thought, people will agree.

We have proposed a standard that we think is appropriate for Fannie Mae. Our portfolio is very well matched, and the suggestions around the table that the portfolio poses some sort of an undue risk is not well taken.

As to low-income housing, one of the absolute facts is that poor people have less opportunity to accumulate money for down payments than do more wealthy people, and therefore a higher percentage of low-income housing and moderate-income housing will be with lower down payments and higher loan to value ratios. Those are riskier loans by any external credit view. We believe we can do them. We don't believe they are unduly risky, but we believe that in seeking to reach a triple A, we would be constrained to have the kinds of portfolio and MBS credit records that everybody agreed looked fine.

I think there's no question but if an unduly restrictive capital standard is imposed, you will find both Fannie Mae and Freddie Mac having to reduce the amount of low-income housing that they do just because of these credit concerns or appearance of credit concerns, more appropriately.

Also, we will have to shrink and not support the market in the way that we have, because the only way to grow—there are two ways to increase capital. One of them is to increase retained earnings. And we can do that by raising our rates, if we are constrained and have to put more capital up against our operations. The other way is to reduce the amount of activity our capital is supporting, to make the capital that we have currently more adequate. And there is no way we believe that we could raise the amount of capital that we expect would be implicit in these phantom triple A for whatever hypothetical business arrangements we would be expected to reach. And therefore we would have to shrink. We would be unable to support the mortgage market. You would have both the credit crunch and the higher interest rates that we have so far been able to avoid.

Mr. **Basham**. Mr. Chairman, if I could respond.

I'm not sure whether Carol is being flip, when she said that they would have to shut down or reduce their commitment to the market, or not.

I think that's a rather extreme statement. Clearly, the issue here is safety and soundness. We think that these are very thinly capitalized corporations. I challenge you to find any major corporation anywhere in the world that can successfully operate on as little capital as these corporations have.

Yes, we did say, Leland, we didn't think there was an imminent threat. I use an old expression: the time to put a new roof on is when the sun is shining, not when it's pouring rain. We did say in our report that they are thinly capitalized, and we are concerned about the fact that there is very little margin for error. We don't know what the next 10 years will be like in the housing market, and we would feel probably more comfortable with some increase in capital.

Where's that capital going to come from? I think Carol is correct. Retained earnings is certainly an appropriate place. David Maxwell is on record as saying that they're going to add almost $2.5 billion worth of capital to their balance sheet by the end of 1991. $2.5 billion from retained earnings is a tremendous amount of money. There are probably not too many corporations in this country that can do that.

I would suggest that if Fannie Mae can add $2.5 billion worth of capital from retained earnings over the next year-and-a-half, what might they be able to do over the next 5 years in terms of adding capital.

And I would also suggest that I don't really see, or I haven't heard anyone complaining about any reduction in service from Fannie during this period, as well. So if they can retain that significant level of earnings that Mr. Maxwell's on record as suggesting is possible, I think they can retain sufficient earnings over 5 years and I think they can meet a reasonable and adequate capital standard.

And to the extent that retained earnings might not be sufficient and it were necessary for them to go into the equity markets, I think it's a very attractive stock. It sells at a multiple of books that would suggest that people think very highly of the company, and I think they would have a fairly easy time in raising some additional equity over that same time horizon.

So we feel it's a reasonable proposal. We don't feel it's extreme. As a matter of fact, if you're double A already, Leland, and double A were to be the level, I don't think you'd have a safety and soundness regulator, I think you'd have other things to worry about. So we view it as a minimalist approach that results in to ensuring safety and soundness for the taxpayer, and at the same time, ensuring that the public purpose constituents continue to receive the benefits without any diminution in service, without any increase in price.

And I think, it also provides for the retention of all the value of the outstanding securities. I know people have suggested that this is some threat to the outstanding securities of these institutions, but the way we've structured our proposals, we don't see it that way. We would disagree.

Senator **CRANSTON**. Ms. Berger?

Ms. **BERGER**. I wanted to make two points.

First, let me address Mr. Basham. I'm an equity analyst and I feel comfortable saying that if Fannie Mae had to raise an undue amount of capital in the market, it would affect that valuation that he points to today. In my remarks, before, I mentioned the risk reward relationship.

What is necessary to continue to tap the capital markets, and the equity markets in particular, is being able to provide a competitive return on equity.

Some of the largest equity offerings by financial institutions have been in the last 12 months, and some of the larger ones have gotten to the size of roughly half-a-billion dollars, but not without impact to those companies' balance sheets and to their returns, and their ability to reenter the capital market's a good example would be Chase Manhattan Bank which did a huge equity offering last October at roughly $40 a share. Today that stock is under $20, and the stockholders that bought on that equity offering are feeling the pinch. And I doubt seriously that Chase Manhattan today could reenter the capital markets, partly because of the dilution that the stockholders suffered on the last equity offering and the fact that the earnings that accrue to those stockholders has been diminished.

So I strongly disagree with Mr. Basham in that ready access to the capital markets requires maintenance of a reasonable competitive return-on-equity. If you change that return by some arbitrary capital ratio, you're going to affect their ability to enter the capital markets, both the debt and equity markets.

And the other point I would like to make is the fact that banks do have their debt rated, but they also regulated by the banking regulators. I don't think that the rating agencies should be the final arbiters of one's credit standards. I do believe in regulation and I do believe in oversight of well capitalized financial institutions. But I don't think that the bond rating agencies have ever been perceived as that final arbiter of risk.

Bank capital standards are set with the view that they have to be sufficient to cover thousands of institutions. They are almost regulated to the least common denominator. Make it simple, make it an equation that can be calculated, that's how the regulator came up with risk-adjusted capital ratios.

I think Congress has a wonderful opportunity. There are not thousands of GSE's; there are a handful of GSE's. And it is possible, through stress tests and other tests, to measure the capital adequacy of each of these institutions without trying to go for that least common denominator and have one arbitrary standard, whether it's triple A or some other standard. I think that they are different in their missions and in their structures. However I don't think it's impossible to determine what is appropriate capital without going to these bond rating agencies for that answer.

Senator **Cranston**. Mr. Edelstein.

Mr. **Edelstein**. The Treasury has legitimate concerns about the risks that would be imposed upon taxpayers. I recognize that, but I feel that it's obvious that if they could create new requirements that raise the amount of capital that Fannie Mae and Freddie Mac have to hold, they'll reduce the risks the taxpayer will face.

But that is, as Ms. Berger and some other people have said, only half of the equation. The other half is what will be imposed upon the system, the country, if you do impose stiffer capital requirements. There will be a reduction in mortgage market activity. I can suggest where that will occur. It's going to happen at the lower end of the credit risk spectrum. And that's going to be low-income and moderate-income households. DUS programs, such as Fannie Mae's, will go by the board, and programs that target these households will be eliminated if there is a capital crunch.

An important issue that really hasn't been asked if you change the capital requirements, what are the impacts on the amount of activity that will occur through Fannie Mae and Freddie Mac. And then what will be the distribution of benefits, who gains and who loses by those changes.

My suggestion is that the Government is and should be the ultimate bearer of risk in the mortgage market; it has to be. If you get a depression scenario, the Government has to be there to help work things out. There's nothing wrong with that. That's exactly the way it should be.

These days, I gather in Washington, worrying about money going out of the Federal till is obviously a deep concern, and it should be. But if we don't have Government taking risks it should be taking, then we're going to be worse off in the long run. And I think the OMB–Treasury proposals may be short-sighted unless they can generate information which proves in fact there will not be a negative impact upon housing production and consumption and all of the people that benefit from the programs that exist through lower interest rates.

Mr. BASHAM. Clearly, Mr. Chairman, the issue of safety and soundness will in all probability require some additional capital on the part of Fannie Mae and Freddie Mac. I would agree with Mr. Stanton there's a good possibility that Freddie Mac is close to having a fairly high level of safety and soundness at this particular point. But it's not clear how much capital is needed.

And again, I would respectfully suggest that, given the level of retained earnings that particularly Fannie Mae is on record as saying they can generate, I think that if they can generate $2.5 billion worth of capital in the next year-and-a-half without any diminution in services, without affecting the low-income programs that are important to housing in America, I think with that kind of track record, it's not too much to suggest that, given a 5-year time horizon, they could make quite a substantial addition to their retained earnings.

I would address Ms. Berger's question in terms of return on equity, I think—I'm not an equity analyst but, I did talk to one who said that he thought the return on equity for the first 6 months of this year for Fannie Mae was probably on the order of around 36 percent, which is a very attractive return on equity. You may differ with that, and it could be somewhat different from that by a few percentage points. But let's say, for argument's sake, he's right.

We have the services of the HUD cashflow model at the Treasury Department. They were kind enough to let us use it. We have it in our computer now and we have done some analysis. If you were to start 1990 with Fannie Mae particularly—we didn't have a chance to do Freddie Mac, Leland, because we don't have your model in the computer yet but we'll get around to that—but we do have the Fannie Mae model in our computer and we assumed that all we did was increase the capital, and just double the level of capital, both the equity as well as loan loss reserves up to a level of $6.8 billion from the $3.4 billion that it was at the beginning of the year. Now, I don't know what $6.8 billion will do in terms of a rating. It could make it a solid double A, it could be a low triple A, but I suggest that that's a substantial amount of capital. And if you had just doubled their capital at the beginning of the year—and you can make a couple of assumptions in terms of either paying down debt or investing in some additional mortgages or other high grade securities—their return on equity did go down. It went down from 36 percent to, depending upon which scenario you want to choose, somewhere between I believe 21 and 23 percent.

Now, you follow financial institutions, and you know that most fairly well run banks, I think, probably do somewhere in the vicinity of 12 to 14 percent. There's another group that are extremely well run that'll do 16, 17, 18 percent on a consistent basis, and I believe B of A, and Wells Fargo, last year, were two all stars that did in the vicinity of around 21 or 22 percent. I would suggest to you that a return on equity of 22 or 23 percent is still a significant return on equity, well in excess of what most major financial institutions, including banks in this country, are able to generate, and would still be attractive to shareholders. I will be the first to admit 36 percent is a lot better than 23 percent. The only reason they can do 36 percent is because they can take the kind of leverage that no other private corporation in America can take. If we request just a little bit more capital, not a dramatic amount, but enough capital to let them continue their programs without any program impact and, at the same time, provide for an additional level of safety and soundness for the taxpayer, and still provide a 20 plus percent return on equity to shareholders, I think that's a program that has some merit.

Ms. BERGER. May I just followup, because he did mention to me, and he was redressing, and I just would like to clarify one thing.

The markets are a little bit more clever than Mr. Basham gives them credit for. Stockholders don't receive that 35 percent at face value. It is discount in the marketplace. Fannie Mae trades at about twice its book value (or equity per share). The S&P 500 sells at about 16 times estimated earnings, and Fannie Mae trades at less than 8 times estimated earnings. What the markets are doing is adjusting for the fact that Fannie Mae does have those capital ratios. What the stockholders are at, because of that discount, the stockholder is not recognizing 35 or 36 percent returns on equity; they are recognizing half of that, roughly, 17 percent. At that return they are trading on a par with others, as you said, well-run financial institutions. The markets are self-adjusting. I mean, that's what the capital market does.

As Fannie Mae builds its capital (book value), its return on equity falls, but the relative multiple that Fannie Mae will trade at will rise over time, and that's how the market works, and that's how the stockholders benefit. As risk to the balance sheet is reduced, there's a natural move towards higher multiples. So that, even though there is a reduced return-on-equity their is a high price to book multiply. But when you artificially suppress that return on equity, the markets must adjust quickly and in general, they overreact, making access to those capital markets impractical and unduly expensive.

Mr. BASHAM. Ms. Berger, we, we——

Senator CRANSTON. Would you wait a minute, please?

Mr. BASHAM. Forgive me, Mr. Chairman.

Senator CRANSTON. Just one second. I'll be glad to let you respond, but I want to make sure Mr. Hunt gets recognized next. He's been trying to get in.

But, before that, may I apologize for the fact that I have to go to the Senate floor now. Don Campbell will finish wrapping this up.

I want to thank all of you for your participation and for the advice and thoughts you've expressed. It's been very helpful, and I got more contradictory statements than I bargained for when I solicited them. But it's been very helpful. I thank you all very much. And please carry on as long as you feel necessary.

Thanks.

Mr. HUNT. Thank you, Mr. Chairman.

A couple of quick points. And I want to move away, obviously, from the discussion of capital, except to make two points: One is our agency has in fact been rated many times by Moody's and S&P. We are a deliverer of housing programs, and I can tell you it is very very difficult to reach a triple A.

Although we certainly cater to a lower income group, we tend to be very financially responsible, and we're lucky to receive a single to a double A rating despite the fact that we have very very low loan losses. We think going to a triple A would jeopardize our ability to deliver to our constituents, and I don't see frankly anybody, I don't think that Fannie Mae or Freddie Mac could do that without severely jeopardizing their public mission.

The second point—and it was raised as a question—is what is the effect when Freddie and Fannie tighten up their underwriting standards. We in Vermont, and I know other States, saw a dramatic effect, frankly, or at least a very strong effect in 1985 and 1986, where a number of loans that we considered to be very very good loans, very sound loans, were no longer purchased by Freddie and Fannie for various reasons. Fortunately, we've been able to design a program in tandem with Fannie Mae to address that problem, but it involved us using our own credit to satisfy them.

That forced us to take on a bigger share of the market than we really felt comfortable with. We want to serve the lowest income people possible. So you have to be very very careful when you're talking about changes in underwriting standards and what their impact is on the marketplace, because it can be very significant to a large number of people.

Mr. CAMPBELL. Mr. Basham, did you?

Mr. BASHAM. Mr. Campbell, I would just note it is 5 o'clock, and if anyone wanted to leave, I would cut my comments off right now.

Mr. CAMPBELL. If anyone wants to leave? Well——

[Laughter.]

Mr. HARVEY. Mr. Campbell, if I can just make one last statement on where regulation ought to be. I think Mr. Basham really answered his own question.

If both these agencies through capital retention are doing so well and are so far down the road, we who are concerned with the public purpose and the housing for low-income Americans would far prefer to go to HUD to argue our case, (in case underwriting standards change dramatically,) because we think we'd have a far better hearing there, for our public purpose, than we would at Moody's and Standard & Poor's, who I think would be quite amazed for us to show up at their door, complaining about what's happening to low-income Americans who are the public policy part of Fannie and Freddie. And from our point of view, Fannie and Freddie are part of the national housing policy, and therefore answerable to HUD, and that is where we go to look for answers to problems that we have in housing low income Americans.

Mr. CAMPBELL. Don.

Mr. SEIDERS. Yes, I just want to say that, as we leave, I hope we all realize that the analogy that Tom Stanton drew between Fannie and Freddie on the one hand, and the thrifts on the other, is a very bad one. And if you look at the data that the Office of Thrift Supervision has on what thrifts got in trouble and what thrifts didn't, it was not investment grade residential mortgages that got them in trouble. That is part of the scare tactics that I mentioned earlier, that gave some momentum to the OMB efforts.

Mr. STANTON. May I please respond?

Mr. CAMPBELL. Certainly.

Mr. STANTON. The thrift crisis was a two-part crisis. What happened was they were specialized lenders, and after Mr. Volker raised interest rates in 1979, they were squeezed on their home mortgage portfolios in their major line of business. By 1981, hundreds of them were woefully uncapitalized. At that point, there was no effective supervision and the Government abdicated all responsibility for serious capital standards. We had income capital certificates, we had net worth certificates, we had all sorts of artificial devices to hide the lack of capital.

So then there were changes of control of many thrifts, and they went out and they bet the bank. And that tremendously compounded the losses we had. What we have today with Fannie Mae and Freddie Mac are specialized lenders that, heaven forbid, within the next 10 years or whatever period of time, could face trouble. I mean, there is ample economic evidence of doctrine on the need to anticipate the remote contingency high cost event. And you've got to have a reasonable oversight process, and you've got to have reasonable capital standards. And we do not have those in place today for Fannie Mae and Freddie Mac. And when your capital is being squeezed in your major line of business, for whatever reason, that is the time the regulators better have something in place to look out as to what's going to happen, and that is the time we will really wish we had a serious capital cushion.

I am not sitting here predicting any sort of doom. What I am saying is that we are playing with probabilities and that it doesn't cost very much to get reasonable capital levels. That's why I keep emphasizing the reasonableness of a double A and reasonable oversight.

Mr. CAMPBELL. As long as we all stay reasonable, we'll be OK.

Mr. **Blampied**. Mr. Stanton missed the point. It still wasn't residential mortgages that got the industry in trouble. I would like to say that the plan, as presented, if implemented, would precipitate a real crisis, a real credit crunch in residential housing, unnecessary in view of everything I hear here today with respect to the present status of Fannie Mae and Freddie Mac, with respect to the capital levels, and no one's disagreeing around the table, that I've heard, saying more capital isn't OK and needed.

Mr. **Campbell**. Yes, sir?

Mr. **Coppens**. I'd just like to make one point. And that is, we've heard the letters triple A and double A uttered at various times today. And I think it's important to recognize that we don't know what double A and triple A mean, yet. Mr. Basham has said that Fannie Mae's plan to retain earnings would be helpful and that, if extended to 5 years, might put them in the zone, but he doesn't know what rating that would get them.

I think we've heard from Mr. Kriz, the representative of Moody's, that he's uncertain as to whether Moody's would be able to act in the advisor role, and that there are currently certain standards that are set for structured finance and for private mortgage insurance, but he questions whether those are applicable to rating the Government-sponsored agencies.

I think that until we get more clarification as to what criteria the ratings agencies are going to be using in arriving at their double A and triple A, and until we know whether the criteria that is the object is double A or whether it is triple A, it'll be very difficult to evaluate the proposal that Treasury has put forward.

Mr. **Campbell**. Are there other comments that are yearning to be made?

Mr. **Gillis**. Well, if I could just make a short comment. And that is that Standard and Poors is certainly willing, if requested—which we have not been—to do that analysis.

Mr. **Campbell**. Well, we'll be working with all of you. I can speak for those members of the subcommittee who are not here. I know that there is determined interest on the part of the members of this subcommittee to make sure that the adequate oversight that you're talking about, Tom, and others have talked about here, are put in place as quickly as possible. Pressure will be continuing on HUD to achieve that as quickly as possible, and make sure that it's done in a way that is well thought through and appropriate to the market and the public purposes of Fannie and Freddie.

Again, I want to thank you, on behalf of Senator Cranston, for first rate hearing, and on one of the most important issues before this subcommittee.

Thank you very much, and the hearing stands adjourned.

[Whereupon, at 5:02 p.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follows:]

DEPARTMENT OF THE TREASURY
WASHINGTON

August 2, 1990

Dear Senator Cranston:

Thank you for inviting the Treasury Department to participate in a roundtable discussion on the safety and soundness of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). The recent failure of many federally insured savings and loan institutions, and the massive Federal funding required to resolve the thrift problem, have focused the attention of Congress and the Administration on other areas in which the taxpayer may be exposed to financial risks. In this connection, FIRREA directed the Secretary of the Treasury to assess the financial safety and soundness of GSEs. As a result of the Treasury Study, the Administration has put forth a proposal that will enhance the safety of GSEs and minimize risk to the taxpayer, while maintaining the ability of GSEs to efficiently and effectively serve America's special credit needs.

We are submitting the statement of the Honorable Robert R. Glauber, Under Secretary of the Treasury for Finance, made on July 26, 1990, before the Subcommittee on Housing and Community Development of the House Committee on Banking, Finance and Urban Affairs.

Sincerely,

Michael E. Basham

Michael E. Basham
Acting Assistant Secretary
(Domestic Finance)

The Honorable Alan Cranston
Chairman
Subcommittee on Housing and Urban Affairs
Senate Banking Committee
United States Senate
Washington, D.C. 20510

FOR RELEASE ON DELIVERY
EXPECTED AT 9:30 A.M.
July 26, 1990

STATEMENT OF THE HONORABLE
ROBERT R. GLAUBER
UNDER SECRETARY OF THE TREASURY FOR FINANCE
BEFORE THE
SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT
OF THE
HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

Mr. Chairman and Members of the Subcommittee:

It is a pleasure to be here today to discuss the Administration's recommendations to enhance the financial safety and soundness of Government-sponsored enterprises (GSEs) and to minimize the potential risk of another costly Federal rescue.

The recent failure of many federally insured savings and loan institutions, and the massive Federal funding required to resolve the thrift problem, have focused the attention of Congress and the Administration on other areas in which the taxpayer may be exposed to financial risks. In this connection, FIRREA directed the Secretary of the Treasury to assess the financial safety and soundness of GSEs. Treasury submitted its study to Congress in May of this year.

Government-sponsored enterprises are entities which have been established and chartered by the Federal Government to perform specific credit functions, but are now, with one exception, entirely privately owned. GSEs generally serve as financial intermediaries to facilitate the flow of credit to private borrowers in three major areas: (1) agriculture, (2) housing, and (3) postsecondary education. They do this by raising funds in the capital markets to make or purchase loans, by issuing pass-through securities, or by guaranteeing the liabilities of others. The GSEs covered by our proposal had borrowed or guaranteed $863 billion by the end of calendar year 1989.

The market's perception of Federal backing for GSEs weakens the normal relationship between the availability and cost of funds to the GSEs and the risks that these enterprises assume. As a result of this perception, GSEs are able to borrow in the market at rates only slightly higher than the Treasury itself pays, but significantly lower than corporations. In addition, they are able to employ much greater leverage in their activities; considerably higher than corporations that do not benefit from any special ties to the Federal Government. This ability to employ greater balance sheet leverage results in significantly higher returns for shareholders, when a GSE is successful, but it can result in tremendous pressure for Government assistance if a GSE encounters financial difficulty.

This is what happened with the Farm Credit System a few years ago and very similar to the problems of excessive risk-taking that occurred in the thrift industry. The asymmetry of this relationship with the Government makes it incumbent upon Congress and the Administration to scrutinize closely the financial stability of the GSEs and the risks associated with their activities.

The S&L crisis will cost the taxpayer a staggering amount of money. There are lessons we learned the hard way from this experience that must never be forgotten. Two of the most important are:

(1) when a business benefits from an explicit or implicit Federal guarantee, it should be required to put up significant amounts of its own equity capital to absorb any losses first, and to provide the business with strong incentives to monitor and control risks; and

(2) there should be effective Federal supervision, and the program regulator should be separate and different from the regulator of financial safety and soundness, which must focus exclusively on limiting unnecessary or excessive risk taking.

President Bush, in his FY 1991 Budget, gave recognition to the underwriting risks associated with Federal credit programs. He suggested that "structural reforms and better incentives for evaluating credit risk can preserve the benefits of Federal credit programs while avoiding excessive Federal risk".

In light of the desire of the Administration and Congress to improve the safety and soundness of GSEs and to correct for the bias toward excessive risk in the GSEs' incentive structures, the Treasury proposed the following guiding principles and recommendations in its study.

Principle 1:	A GSE Should Be Adequately Capitalized, Meet High Credit and Operational Standards, and Be Subject to Effective Government Supervision or Congress Should Terminate All Government Ties with the GSE.
Principle 2:	A Private Market Mechanism Should Be Used to Evaluate GSE Risk.
Principle 3:	The Program Regulator Should Be Different from the Implementer of Financial Safety and Soundness Standards.
Principle 4:	The Value of the Government's Financial Support Should Be Disclosed.

We believe these principles should form the basis for any proposed legislation that would address the issue of financial safety and soundness of GSEs. More specifically, the Administration would suggest that any legislative initiative might include the following elements:

I. Require each GSE to obtain a triple-A rating, without regard to any implicit or explicit Federal guarantee, from two nationally recognized statistical rating organizations within 3 months of passage of legislation, and annually thereafter.

The Administration is convinced that a triple-A rating is appropriate because it represents the most safe and sound level of credit quality in the private sector, and thereby the best protection for the taxpayer from potential risk. Three of the GSEs probably already qualify for a triple-A rating exclusive of Government support. If these GSEs can efficiently and effectively meet their public purpose with a triple-A rating, this is a reasonable request to make of other GSEs. To suggest a lower level of creditworthiness would provide incentives for these highly rated GSEs to take more risk. We feel this is the wrong message to send.

Because GSEs are (with one exception) privately owned corporations, we feel it is appropriate to use a private market mechanism to evaluate each GSE. These rating organizations are better able to focus on the full range of factors that affect creditworthiness, not just capital alone. Given the uniqueness of each GSE and the diversity and complexity of their operations, this approach provides a superior method for evaluating the Government's potential risk. At the same time it provides the GSEs with the benefits of sophisticated credit analysis, rather than requiring them to adhere to a single standard that does not recognize their unique characteristics. This solution is also better than subjecting GSEs to a formal system of comprehensive regulation and oversight similar to that for banks and thrifts.

The rating requirement is in no way an abdication of the Government's responsibility to oversee the activities of GSEs. It only uses private sector analysts to assess the creditworthiness of each GSE, while leaving the actual safety and soundness oversight to the Federal Government.

II. Require that a GSE which initially fails to obtain two triple-A ratings develop and submit to the Treasury a comprehensive business plan, acceptable to Treasury, that shows how the GSE intends to achieve the rating no later than 5 years from the passage of the legislation.

If the GSE does not adhere to the business plan, Treasury would be authorized to impose sanctions that could include limits on dividend payouts, financial leverage, and/or debt issuance. These limitations are similar to the powers HUD currently has with respect to Fannie Mae and Freddie Mac. If in subsequent years, after achieving the triple-A rating, the rating of a GSE falls below triple-A, the GSE would be required to submit a new business plan detailing how it would re-establish its rating within two years.

Some GSEs have said that any business plan would require them to raise too much capital and force them to either shut down their operations or to reduce their level of service. Statements such as this are unwarranted. The use of the rating organization's sophisticated credit analysis allows for the development of business plans by a GSE that do not focus exclusively on capital as the only means for reducing risk. Clearly, a GSE that is not rated triple-A would probably need to raise some amount of additional capital. However, the amount needed is not arbitrary or fixed, it will vary according to the level of risk a GSE chooses to undertake in its operations. Any plan that modifies or reduces the risk inherent in the GSE's activities should result in a lower need for capital to achieve the necessary rating.

III. Eliminate special Federal characteristics of new obligations issued or guaranteed by a GSE after it fails to obtain the required triple-A rating.

If a GSE fails to obtain a triple-A rating by the end of the five year period after legislation is passed, the GSE itself would retain all of its special ties with the Government, including its Federal charter and its discretionary authority to borrow from the Treasury. However, any obligation issued or guaranteed after that date, and until the triple-A rating was obtained and maintained for one year, would lose some of the special Federal characteristics that the other GSE securities have. These could include eligibility for bank or thrift unlimited investment, exemption from SEC registration, treatment as Government securities under the Securities Exchange Act of 1934, and exemption of interest paid from State income tax.

Elimination of these special characteristics would not impair the ability of the GSE to continue to issue debt or guarantee pass-through securities. It would attempt to place these securities on an equal footing with other corporate and mortgage backed securities.

Only newly issued securities would be affected by our proposal. All outstanding debt and guaranteed securities would not be affected. In fact, they would continue to have the same unique GSE characteristics they had when they were purchased. As a result, holders of existing GSE securities would not suffer any loss of value, and more importantly, holders of GSE debt would receive the additional benefit of having financially stronger credits underlying their securities.

IV. Provide for a financial safety and soundness regulator which is separate and different from the program regulator.

The Administration strongly believes that the regulatory authority which oversees a GSE's program, or fulfillment of its Congressionally mandated public purpose, should be separate from the entity responsible for safety and soundness. There may be an inherent conflict if the entity responsible for seeing a GSE succeed from a programmatic perspective must switch roles to become an effective advocate of safety and financial soundness. Separating these two regulatory functions will minimize risk to the taxpayers by eliminating the potential for regulatory conflict of interest. That is why FIRREA divided the thrift regulator's chartering and chief supervisory functions from its insurance function, assigning the former to the Office of Thrift Supervision and the latter to the FDIC.

The Administration's proposal would have the current program regulator continue to be responsible for ensuring that the GSE meets its Congressional mandate by effectively serving its intended beneficiaries. For example, the Department of Housing and Urban Development would continue to exercise specific and general regulatory oversight over Fannie Mae and Freddie Mac, including new program approval, and provide assurance that they meet their obligation to provide ongoing assistance to the secondary market for home mortgages. Issues related to ensuring that a GSE meets the requirements for a triple-A rating would be dealt with by the Treasury as the safety and soundness regulator.

As I said at the outset of my testimony, the need for Congress to provide financial assistance to the Farm Credit System, and the catastrophic cost of the thrift crisis have effectively drawn the Federal Government's attention to one simple and undeniable conclusion. When the implicit or explicit guarantee of the Government is "on-the-line," there must be effective Federal supervision and there must be significant private equity capital at risk to protect the taxpayer from the potential risks of another costly Federal rescue. We believe that the Administration's recommendations would achieve these objectives.

In conclusion, our recommendations would:

(1) most importantly, provide for enhanced safety and soundness to protect taxpayers still reeling from the cost of the thrift bailout;

(2) ensure that the public purpose constituents will continue to receive the benefits Congress intended

without disruption or needless increase in price, both now and well into the future;

(3) protect the status and value of all of the outstanding securities of the GSEs; and

(4) minimize the regulatory burden on the GSE if it is already triple-A, or once it becomes triple-A.

Very simply, the Administration's approach will enhance safety and minimize risk to the taxpayer while maintaining the GSE's ability to efficiently and effectively serve America's special credit needs.

This concludes my prepared statement. I will be happy to answer any questions that you may have.

o 0 o

Standard & Poor's Corporation
Submission to the Senate Subcommittee on Housing and Urban Affairs

This background paper has been prepared for the Subcommittee on Housing by members of the Debt Rating Group of Standard & Poor's Corporation. You have asked us to discuss the risk factors involved in the credit quality of private sector companies which have comparable characteristics to the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Secondly, you have asked us to highlight the differences between Fannie Mae and Freddie Mac and these private sector companies.

Standard & Poor's has maintained a 'AAA' assessment of Fannie Mae and Freddie Mac since 1983. While the 'AAA' is based on the implicit support of the federal government, Standard & Poor's looks at the underlying business fundamentals. Fannie Mae and Freddie Mac are unique entities, but there are structural and balance sheet similarities to certain housing related private industries.

Standard and Poor's believes that capital is only one factor affecting credit and it is important to recognize all the major factors which working together make up credit quality. It is for this reason that we discuss below a number of areas that go into credit analysis. Certain factors for each industry may be weighed differently in our analysis and you will see this in the discussion.

The two industries which are relevant to Fannie Mae and Freddie Mac are the mortgage insurance industry and the portfolio lending side of the thrift industry. While Freddie Mac's organization and structure is most like a private mortgage insurer, Fannie Mae has two business lines: the largest of the two, mortgage backed securities (MBS), resembles a mortgage insurer and the smaller side of Fannie Mae's business resembles a portfolio lender. Both business lines involve taking on credit risk. However, portfolio lending involves taking on interest rate and funding risk since the holder of the mortgage must finance its holdings.

Analysis Relating to Off-Balance Sheet Participation Certificates and Mortgage Backed Securities

Virtually all of Freddie Mac's business and about two-thirds of Fannie Mae's business is most similar to the mortgage insurance industry. The issuing of PC and MBS guarantees is similar to the insurance provided by private mortgage insurers or financial guarantors. Standard & Poor's looks at six major factors in a review of mortgage insurers:

*Industry risk and market strategy
*Management
*Asset quality (Insurance Portfolio Review)

*Operational performance
*Liquidity/Financial flexibility
*Capitalization

The industry risk analysis reviews the forces driving industry competition and competitive strategies. An overall industry outlook is formed, incorporating such elements as demand, market share and cost structures. Capital requirements are also examined, and an assessment is made as to an appropriate return on capital and the ability of companies to attain and sustain an appropriate return. Competitive strategies are also examined. Fannie Mae and Freddie Mac have virtually no competition except each other, but it would be important to analyze the business strategies of each including market share, product, loan type and pricing projections.

Assessment of the company's management has significant impact on the rating eventually assigned. Important elements of this analysis include the experience, background and tenure of senior management at the company as well as the organizational structure and depth of management. Financial and operational strategies are reviewed, as is evidence of an ability to implement strategies successfully. This factor should be fully analyzed for Freddie Mac and Fannie Mae.

Asset quality is primarily a function of the insurers underwriting guidelines. The business review component of the rating process examines the asset quality of the insurer's off balance sheet "mortgage portfolio" in the areas of concentrations of risk by location, product type, loan feature and year of origination. Additionally, book of business performance in terms of delinquency and claim results are reviewed by product type, loan feature, geographic location and year of origination. This review can oftentimes identify underwriting inconsistencies and/or pricing deficiencies.

It would be appropriate to evaluate both Freddie Mac and the MBS side of Fannie Mae in this area. As is the case for mortgage insurers, questionable product development or excessive geographic concentrations disclosed by the business review analysis could warrant adjustments to capital adequacy assumptions.

Operating performance and capitalization (capital adequacy) are viewed as the most important components of the mortgage insurer rating process. In order to be able to attract new capital, returns to investors must ultimately be commensurate with the risks posed by a monoline financial guaranty product line. Earnings, dividends and surplus growth track records are considered. A company's underwriting profitability is reviewed and measured by its loss, expense and combined ratios. Reserve adequacy is assessed by reviewing a company's reserving methodology and its relative conservativeness. Investment activities are evaluated in terms of performance, risk profile, and contribution to total operating results. Standard profitability measurements such as return on assets and return on equity are reviewed on a historical and prospective basis.

Mortgage insurance companies, given their monoline nature and strong correlation with housing and economic cycles, are potentially subject to catastrophic loss. For a 'AAA' assessment, capitalization must be sufficient to withstand a capital stress test.

Standard & Poor's capital adequacy model is a stress test used to assess the performance of mortgage insurance companies during a simulated depression. The nature of mortgage insurance and its close ties to the business cycle make it necessary to address the potential impact of widespread national default caused by a severe economic depression.

Standard & Poor's assumes the following in measuring a company's capital adequacy.

1) Net risk in force is used as the basis of a company's exposure against which capital is measured.
2) For four-year old risk in force, a 4% foreclosure or frequency rate for a four-year depression is used.
3) For risk in force more than four years old, a 2% foreclosure or frequency rate for a four-year depression is used. More seasoned business is assumed to have a lower default rate.
4) The severity of loss for each foreclosed mortgage is assumed at 125% of the insurers risk in force.
5) Renewal premium income is credited at the company's actual weighted average renewal rate.
6) Interest on the company's investment portfolio is credited at 5% per year. This assumption reflects reinvestment risk and a declining investment portfolio.
7) Investments in parents, subsidiaries, and real estate are subtracted from surplus.
8) One half of the unearned premium reserve is credited as capital since this level will flow into the contingency reserve as earned.
9) If the mortgage insurer has a national dispersion of pool risk, capital necessary to support pool insurance is equivalent to primary requirements. Severity is assumed at 110% pool exposure.
10) Operating expenses are assumed to be minimal, given the cessation of new business activity.

Using this information, Standard & Poor's calculates funds available to pay claims, measures these funds against the total expected claims, and calculates any capital shortfall or redundancy. In meeting the claims simulated in the depression scenario, the stability and quality of capital sources are analyzed. Thus primary capital is regarded highly, whereas no credit is given to a support agreement from a weak parent.

Standard & Poor's gives 100% credit to reinsurance treaties or formal parental support agreements based on the reinsurer's claims paying ability rating or the parent's senior debt rating. The dollar impact of any reinsurance treaty or support agreement is quantified, the terms are reviewed, and the effect on the financial strength of a mortgage insurer under normal and stress scenarios is evaluated.

The "stress test" which Standard & Poor's developed for the mortgage insurance industry would not be appropriate for Fannie Mae or Freddie Mac. Capital should be measured against an adjusted stress test for each. The most important adjustment would recognize a lesser foreclosure frequency and loss severity for Freddie Mac PC's and Fannie Mae's MBS, which benefit from first loss coverage provided (for loans with loan to value ratios in excess of 80%) by the private mortgage insurance companies. Thus loss coverage for LTV's of less than 80% would have to be applied in a stress test for Fannie Mae or Freddie Mac. In addition, Fannie Mae and Freddie Mac both purchase multi-family housing loans which is not typical of mortgage insurers. These and any other factors unique to the business of Fannie Mae and Freddie Mac would have to be incorporated into the stress test to provide an appropriate measurement of credit.

Given potential catastrophic losses, and resulting cash requirements to pay large amounts of claims in short periods of time, a company's liquidity and its ability to sell or redeploy assets, borrow, or issue stock is examined under normal and adverse scenarios. Because of authorizing legislation providing "agency status" for the securities, both Fannie Mae and Freddie Mac have always been able to access the capital markets. This has provided a continuing and stable form of liquidity.

Both Freddie Mac's and Fannie Mae's authorizing legislation provide for the Secretary of the Treasury to lend up to $2.25 billion through the purchase of Fannie Mae or Freddie Mac securities. While this can be taken into consideration in liquidity analysis, the "line of credit" is discretionary. Thus, we would not give full credit to this support.

The factors discussed above would be applied to virtually all of Freddie Mac's business and to the MBS side of Fannie Mae's business. Unlike Freddie Mac, Fannie Mae also holds a sizeable portfolio of loans. To evaluate this side of the business it would be appropriate to use the portfolio analysis for the thrift industry. While some of the factors such as assessment of management and underwriting guidelines apply to all areas of the business, holding a portfolio of loans creates separate risks. Because Fannie Mae issues corporate debt to fund the purchase of its loans held in portfolio, interest rate risk management is a more important element of analysis for Fannie Mae than for Freddie Mac. However, there are factors analyzed for thrifts which would not be appropriate for this analysis. The most obvious one is the depository role of the thrift. In addition, thrift analysis includes an evaluation of any commercial and consumer lending activity which would not be present at Fannie Mae and Freddie Mac.

Analysis Relating to the On-Balance Sheet Portfolio

Major factors which are evaluated in the analysis of the portfolio lending aspects of a thrift are:

*Management
*Interest rate management
*Industry risk and market position
*Operational performance
*Asset quality
*Accounting
*Capitalization

Evaluation of management would be essentially the same for a portfolio lender as a private mortgage insurer. Depth and experience, financing policies, and a comparative review of operational results would be reviewed. Another factor in the review of a portfolio lender would be methods used by management to assess interest rate risk. Management's approach to evaluating its interest rate risk as rates go up or down can influence credit. The use of short term debt to finance long term assets such as mortgages can leave the portfolio lender open to interest rate risk. As interest rates rise, interest expense would rise more rapidly than interest income and the net interest margin would be squeezed. From a credit perspective, a matched position in which the maturities of assets and liabilities are similar is best. This factor is of much more importance in an evaluation of Fannie Mae because of its large portfolio holdings. While Freddie Mac is subject to some interest rate risk, it's portfolio is such a small portion of its business that this is not a major factor in the overall evaluation.

We view industry risk for a portfolio lender as high. The combination of asset, interest rate and funding factors can provide a high risk environment. While single family mortgages tend to be low risk in and of themselves, they are long term assets. This long term nature of mortgages combined with the attractiveness of short term funding (assuring an upward yield curve) could lead portfolio lenders to carry a mismatch between the maturities of assets and liabilities, thus exposing the portfolio lender to interest rate risk. This needs careful analysis and monitoring. Market position evaluates the strength that a company has within its industry.

The most comprehensive measure of financial or operational performance is return on assets. Included in this analysis is both amount and quality of reported earnings. Net interest income is the most important source of quality earnings which depends primarily on the volume and type of earning assets or loans being held in the portfolio. The higher the assets in quality the less the spread or earnings. Conversely the lower the quality the higher the spread. A portfolio solely made up of fixed rate single family mortgages is likely to yield less than a portfolio of adjustable rate single family mortgages and multi-family mortgages and provide less in earnings. Standard & Poor's takes into consideration the portfolio lender's provision for loan losses as well. The greater the amount of credit risk, the larger the provision will be. Operating expense must be analyzed also. The ability to control expense can be a good indicator of management's overall competence. This also shows how these factors interrelate with each other and the importance of management in the analysis. While these are only some of the factors reviewed in the financial performance of a thrift, they are the ones that would be most important to evaluate for Fannie Mae's or Freddie Mac's portfolio.

The credit quality of a thrift is largely dependent on the diversity and quality of its portfolio of earning assets. Fixed rate single family mortgage loans have historically been low risk investments. As with mortgage insurers Standard & Poor's pays careful attention to the underwriting guidelines and the track record of the portfolio lender. The portfolio's proportion and inclusion of adjustable rate mortgages, negative amortization loans, and jumbo loans can mean riskier assets. We feel that higher risk assets must be supported by an appropriate level of profitability and adequate capitalization and reserves.

Accounting quality is traditionally analyzed in thrift evaluations. Important factors in this area have historically been use of GAAP or RAP accounting principles, recognition of fee income, impact of accounting for mergers and acquisitions. These concerns do not apply to Fannie Mae and Freddie Mac.

Finally, for a portfolio lender capitalization should be at a level to provide comfort to cover the risk of the portfolio. Standard & Poor's believes that a risk adjusted approach to capital adequacy for a portfolio lender conveys the best sense of financial strength. Thus, both asset quality and the portfolio's ability to withstand interest rate moves are important factors in the evaluation of capital needed for a portfolio lender. Because of Fannie Mae's two business lines, the capital needed for the portfolio would be in addition to the capital needed to support the MBS side of Fannie Mae's business.

Public Securities Association
1000 Vermont Avenue, N.W.
Suite 800
Washington, D.C. 20005
(202) 898-9390

PSA

STATEMENT OF W. H. HAL HINKLE
CHAIRMAN, MORTGAGE-BACKED SECURITIES EXECUTIVE COMMITTEE
PUBLIC SECURITIES ASSOCIATION

ROUNDTABLE DISCUSSION OF THE SAFETY AND SOUNDNESS
OF THE FEDERAL NATIONAL MORTGAGE ASSOCIATION
AND THE FEDERAL HOME LOAN MORTGAGE CORPORATION

SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS
SENATE BANKING COMMITTEE

AUGUST 2, 1990

Mr. Chairman and Members of the Subcommittee, I am pleased to have the opportunity to participate in this roundtable discussion of the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC). I am Vice President and National Product Manager in the Mortgage Securities Department at Goldman, Sachs & Co. In this discussion, however, I do not represent my firm, but the Public Securities Association (PSA), where I serve as Chairman of the Mortgage-Backed Securities Executive Committee. The PSA is an international trade association of over 300 banks and brokerage firms that trade and underwrite mortgage-backed securities, U.S. government and federal agency securities, municipal securities, and money market instruments. On behalf of the PSA, let me thank the Subcommittee for the invitation to participate in this discussion.

For analytical purposes, the issue of the safety and soundness and regulatory oversight of FNMA and FHLMC can be viewed from two directions: (1) the implicit or explicit risk borne by the federal government as a result of the operations of FNMA and FHLMC and (2) the real or perceived risk borne by investors in the securities of FNMA and FHLMC. The first risk is a matter of national policy to be determined at the federal level. The appropriate level of the risk for the federal government to assume must be balanced against the benefits accruing to society from the fulfillment of national housing policy goals through the endeavors of FNMA and FHLMC. The second risk follows from policy decisions about the appropriate level of federal risk and about the degree to which FNMA and FHLMC should act as public or private agencies.

As an association of participants in the secondary mortgage market, PSA is more qualified to discuss this second component of the safety and soundness issue, that is, how various proposals to change the regulation of FNMA and FHLMC could affect the level of real or perceived risk borne by investors, and hence the probable market reaction to the prospects and actualities of regulatory change. Accordingly, where appropriate, we will direct our discussion towards this view, where PSA represents a voice from the capital markets and investors.

The invitation to testify posed four issues for discussion. We will organize our remarks around these topics. Since two of the issues are integrally related, we consider these singly under the second heading below.

1. Capacity Needed by HUD to Conduct Oversight of FNMA and FHLMC

In its reports on FNMA and FHLMC, HUD describes its plan to establish an Office of Regulatory Functions, to consist of economists, lawyers, accountants, secondary market experts, and program analysts to provide the technical expertise necessary for oversight of FNMA and FHLMC. Accepting the development of an independent analytical oversight capability, we encourage HUD to make use of the private sector to obtain the commonly accepted data series that are critical for thorough analysis of the secondary mortgage markets. In particular, HUD should consult PSA for information on mortgage prepayment history and analytics and price volatility in the secondary market, the Mortgage Bankers Association for mortgage delinquency and foreclosure data, and the National Association of Realtors for trends in home values. By using these established sources of information, HUD will not only ensure that it has the most commonly accepted data available, but will also save time and cost, since it will eliminate the need to generate and produce this information itself.

2. Effects of Treasury/OMB Proposals on the Ability of FNMA and FHLMC to Carry Out Their Policy Missions and their Ability to Raise Capital

Ultimately, the ability of FNMA and FHLMC to carry out their housing missions is a function of their financial health and federal sponsorship, so efforts to strengthen the financial base of these agencies can be consistent with other long-term policy goals. There may, however, be tradeoffs between budget and housing policy associated with the Treasury and OMB proposals.

Other things being equal, requiring higher capitalization for FNMA and FHLMC might tend to reduce their return on equity and increase their costs, possibly conflicting with their mission to support the secondary mortgage market. Limiting the leverage of FNMA and FHLMC could, on its face, reduce the amount of credit these organizations make available to support the mortgage market.

The effects of increasing the required capitalization for FNMA and FHLMC might be offset by an increase in their perceived creditworthiness and a willingness by investors to accept lower yields on instruments guaranteed by FNMA and FHLMC because of a perception of lower risk. It is possible that some investors may see increased federal scrutiny and regulation of FNMA and FHLMC as evidence that the federal government does feel a responsibility to stand behind these agencies in the event of a crisis. In other words, federal concern about the potential costs of its implicit guarantee might serve to demonstrate to investors that there is a high probability that this guarantee does, in fact, exist. In these circumstances, investors might be willing to accept FNMA and FHLMC instruments as even closer substitutes for Treasury securities than is presently the practice, to the benefit of FNMA, FHLMC, and their housing mission.

Limiting the ability of FNMA and FHLMC to take certain risks would have effects similar to increasing capital. Constraining their ability to take broadly supportive positions in the housing market could hinder their housing finance mission and reduce their profit potential, thereby raising their cost of capital. But these problems could be offset to a degree by increased creditworthiness.

Since an active private mortgage market exists on the margin of FNMA and FHLMC's activity, any regulation that increases the cost of business for FNMA and FHLMC would likely imply a reduction in market share for FNMA and FHLMC and an increase for private market participants. Since private market participants do not enjoy certain advantages available to FNMA and FHLMC, however, such a development might result in increased mortgage costs to homebuyers. This increase would constitute the price, relative to the housing mission of FNMA and FHLMC, that the Federal Government would pay for reduced risk. Any retrenchment in the presence of FNMA and FHLMC will create a vacuum that participants in the private secondary mortgage market will have to fill.

Most important, whatever course is chosen, it is imperative that the risks to investors be carefully and accurately articulated and that risks facing existing investors not be altered by changes in federal policy. If investors are faced with uncertain risks because of the potential for changing regulation of FNMA and FHLMC, they will charge a penalty, in the form of a higher yield, on all instruments guaranteed by these agencies. Such a result would benefit neither the agencies nor housing policy.

3. Separation of Program Regulation and Regulation of Safety and Soundness

As with most issues relating to FNMA and FHLMC, the choice of an appropriate regulatory structure involves significant tradeoffs. To the extent that increased risk-taking allows FNMA and FHLMC to be more active players in the mortgage market, trade-offs exist between the safety and soundness of these agencies and their policy mission. One legitimate response to these tradeoffs would be to separate program oversight from oversight of the safety and soundness of the agencies, and thereby push the policy debate over the appropriate balance of risk and mission to a higher, perhaps Congressional, level. Under this arrangement, each regulator would be given a specific, and relatively objective charge. The balancing between their charges would be a matter to be determined by Congress.

Conversely, it could be argued that separating the regulatory oversight functions would frustrate the fulfillment of the agencies' policy mission because any risk-taking to support the housing market might be harshly regulated by the safety and soundness regulator. According to this view, it would be more productive to consolidate regulation, and force the regulator to develop practical policies that promote the housing mission, while maintaining adequate constraints against excessive risk-taking.

Conclusion

Determining an appropriate set of regulatory goals for FNMA and FHLMC involves making delicate tradeoffs between the housing mission of the agencies and the risks these agencies pose to the federal government. Moreover, the market effects of certain proposed regulatory changes are difficult to determine precisely in advance: on the one hand the proposed changes reduce the profit potential of the agencies; on the other, they increase the agencies' creditworthiness. However the regulatory issues are resolved, it is critical that the interests of investors be protected. The risks associated with holding instruments guaranteed by FNMA or FHLMC need to be clearly articulated and investors need to be assured that, while they cannot be insulated from market risks, the risks they face as a result of regulatory policy will not change over time. In this way, regulators can avoid the unnecessary penalty that the market will exert on the agencies because of uncertainty about regulatory policy.

Statement of

CARYL S. BERNSTEIN

EXECUTIVE VICE PRESIDENT, GENERAL COUNSEL AND SECRETARY

FANNIE MAE

Before the
SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS
of the
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
of the
UNITED STATES SENATE

AUGUST 2, 1990

Mr. Chairman and members of the Subcommittee, I am Caryl Bernstein, Executive Vice President and General Counsel for Fannie Mae. Fannie Mae very much appreciates this opportunity to discuss with the Subcommittee the issues presented by HUD's recent decision to review its regulatory regime for Fannie Mae and Freddie Mac, as well as its recent Annual Reports to Congress on the two companies.

Fannie Mae is a congressionally chartered, privately owned company whose sole business is to support housing finance through the secondary market for residential mortgages.

With our congressional mandate of providing ongoing assistance and liquidity to the primary mortgage market, Fannie Mae is pivotal to home finance delivery. We are the nation's largest investor in mortgages secured by properties for low-, moderate- and middle-income families and a major issuer of mortgage-backed securities (MBS) backed by those mortgages. As of June 30, 1990 we had almost $113 billion of mortgage loans in our portfolio and had outstanding approximately $263 billion of guaranteed mortgage-backed securities backed by loans Fannie Mae holds as trustee for the securities' owners.

Fannie Mae made mortgage money available to over 7 million American families in the 1980s. We channeled $450 billion of mortgage money from the financial markets to home buyers, purchasing mortgages with an average balance of $60,000. In the 1990s, we will finance homes for at least 10 million more families.

Over and above what we do for moderate-income families, we're generating new housing finance solutions aimed at Americans with lower incomes. In the past two years alone, we targeted over $4 billion to expand housing opportunities for 80,000 low- and moderate-income American households. Our mission is directed not only at home buyers but those who rent their homes as well. We have strengthened our multifamily program in the past three years and now have directed over $15 billion to local housing markets for the financing of multifamily housing, keeping rent affordable for 400,000 apartment dwellers with average incomes of $20,000.

Our benefits to housing derive from operating efficiencies resulting from our charter, and the large scale of our operations. Most recently, Fannie Mae and Freddie Mac have become even more critical to buffer turbulence in the primary markets. Since enactment of reforms in the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (or FIRREA), many thrifts have curbed portfolio holdings of home loans and increased sales to secondary market investors. Fannie Mae and Freddie Mac have successfully ensured the continued flow of mortgage credit to home buyers by increasing their share of new mortgages funded and guaranteed.

I. POSSIBLE NEW HUD REGULATORY INITIATIVES

Fannie Mae welcomes HUD's recent initiative to review its structure for regulating Fannie Mae. Post-FIRREA changes in the housing markets, and HUD's new role as regulator of Freddie Mac, warrant careful review of HUD's regulatory structure for Fannie Mae. We have communicated to HUD a list of our recommendations for consideration, which include that the regulatory structures for Fannie Mae and Freddie Mac should be substantially identical.

In its annual reports on Fannie Mae and Freddie Mac, HUD outlined a number of recent and planned reforms. These include creation of a Financial Institutions Regulatory Board, the planned creation of an Office of Regulatory Functions to provide added analytical resources for GSE oversight, and continued development of financial and stress models to assess risk and capital adequacy. We believe that competent people with appropriate skills who approach the regulatory function from the proper perspective are key to effective regulation. In that context, HUD certainly appears to be proceeding in a responsible way to strengthen its oversight of the housing GSEs.

II. NEW DEFINITIONS OF CAPITAL ADEQUACY

A. HUD's Approach to Capital

The HUD Annual Report also recommends stress tests as the means to measure capital adequacy and discusses the principles for such testing. We are very pleased that the Report confirms our own view that using models and stress tests leads to the most appropriate measure of capital adequacy. We look forward to assisting HUD as it further refines effective models for stress testing. We will work with HUD as well to develop a methodology for mark-to-market balance-sheet reporting for both Fannie Mae and Freddie Mac.

The HUD stress test results echo the recent Treasury report and GAO testimony and the Administration's statement in its 1991 budget submission: Fannie Mae and Freddie Mac are healthy and currently pose no risk to the government. In fact, under HUD's "worst case" interest rate scenarios, Fannie Mae handily weathers a very stormy economic scenario over a prolonged period.

Specifically, as to interest rate risk, the Report found that Fannie Mae could withstand severe interest rate swings unprecedented in the 20th century and which "no serious forecaster" contemplates. HUD concluded that:

- Assuming OMB/Treasury rates rose to around 18 percent and remained there for a decade, Fannie Mae would continue to report profits for 7 full years;
- Assuming OMB/Treasury rates rose to around 23 percent (5 percentage points higher than the 18 percent scenario) and

> remained there for a decade, Fannie Mae would continue to accumulate earnings and capital for two years and would only in the fifth year begin to show losses.

These results also underline Fannie Mae's strength because HUD gloomily assumed no public or private remedies to halt deterioration and zero corporate growth.

In its Annual Report HUD refers to the Treasury Report's comments on Fannie Mae's stress tests for credit risk. HUD did not do an independent analysis prior to writing its Report. The HUD Report states HUD's intention to develop stress test models to gauge Fannie Mae's ability to withstand declines in housing values and to use this approach to develop a recommended capital standard for Fannie Mae. Meanwhile, HUD recognizes that "[i]n both...credit risk and interest risk...the magnitude of change in [Fannie Mae's] operating environment that would have to occur to cause a problem is large relative to the experience of the past several decades and relative to the range of conceivable economic scenarios."

III. CRITIQUE OF OMB/TREASURY'S AAA PROPOSAL FOR GSES

In hundreds of pages of analysis and budget documents, neither the GAO, Treasury, OMB nor HUD has suggested that Fannie Mae is anything but strong and getting stronger. No one has asserted that we are in crisis. No one has suggested we would contribute to the budget deficit. No one has questioned the contribution we make to housing. Yet recently, OMB and Treasury submitted Proposals to the budget summit that would fundamentally alter the way Fannie Mae and Freddie Mac do business -- and would do so without the usual substantive legislative process.

Their Proposals would require Fannie Mae and Freddie Mac to get AAA ratings from two private rating agencies, and to do so in three months. The rating would have to be made without regard to any implicit and explicit federal guarantee or other benefit, including the ability to raise billions of dollars each year at agency rates in the credit markets. Failure to meet the standard within three months would require Fannie Mae or Freddie Mac to submit to Treasury a business plan to obtain the AAA within five years. If Treasury did not approve the plan, Treasury itself could write an alternative plan.

Failing to submit or meet an acceptable plan -- and presumably, submitting an unacceptable plan -- could mean Treasury could impose limits on dividends, growth, debt issuance, salaries and leverage. Treasury would be authorized to write new regulations and could supersede any inconsistent regulations of any other agency.

Fannie Mae fully supports the general principles described in Treasury's Report of May 31: adequate capitalization of GSEs, high credit standards, and effective government supervision. Our management philosophy and capital planning already embody these tenets. We urge the Congress to take any and all steps needed to reach these goals, but to do so in your normal deliberative style, after careful examination and consideration of the suggested approaches and their consequences.

We are unable to find any link between these goals and the recent OMB/Treasury Proposals to the budget summit. In our view, the AAA Proposal is extreme and rash. It provides no reasoned analysis to support adoption of this particular standard or the method for establishing it. It sanctions wholesale abdication of the government's duty to balance the societal benefits and costs associated with GSE operations.

And adding insult to injury, it asks the summit members to reverse course in housing policy without even considering the GAO studies Congress designed specifically to consider and recommend GSE capital standards, while taking into account the costs and benefits of such standards.

The best summary of this approach is "Ready, FIRE, aim!"

Rational policy will remain elusive if Congress is not given the opportunity for thoughtful consideration. Basic policy issues inherent in the AAA Proposal have never been raised -- much less debated or analyzed thoughtfully -- by the Administration's representatives or any committee of Congress. We believe that responsible policy making in this arena demands rigorous review of the issues before any action is taken.

So we urge the members of this Subcommittee and other congressional policy makers to step back and carefully weigh the likely consequences of the OMB/Treasury Proposals for GSEs. We believe adoption of these Proposals would paralyze Fannie Mae's and Freddie Mac's ability to provide adequate liquidity to mortgage lenders. This would provoke a housing credit crunch and raise the mortgage costs for millions of low- and moderate-income home buyers.

Outlined below are six major areas that demand the most painstaking consideration.

A. USING RATING AGENCY EVALUATION PUTS WALL STREET IN CHARGE OF GSE SUPPORT FOR HOUSING AND HOME BUYERS.

The Proposal to use rating agency standards would abdicate government's role in setting the course for housing policy. Adopting the Proposal would delegate to a handful of Wall Street firms public decisions of tremendous import. It could put firms such as Moody's, Standard and Poor's, and Fitch in a position to dictate which states will receive housing credit in the next recession, and which categories of consumers will get home mortgages. Yet these organizations have been given no responsibility or accountability for the public interest in housing finance, or other non-credit matters, and they do not make public the criteria on which they base their rating distinctions.

B. THERE IS NO GOOD BASIS FOR THE AAA REQUIREMENT.

No one really knows what it would take for a housing-finance GSE to get the AAA, especially when it is evaluated as a hypothetical business, without regard to its borrowing ability and other GSE attributes. Treasury tacked its AAA Proposal onto a study with a very narrow focus on GSE risk and capital levels. GSE public purposes and benefits were not considered -- indeed, considering them was not part of Treasury's mandate. Congress was looking to the GAO's studies and its own procedures for this aspect of the evaluations. The only reason Treasury gives for the AAA is that it is the highest, safest credit rating. OMB has now simply added itself to the Treasury approach. However, there is no suggestion that a different standard would impose any undue risk on the taxpayers. The AAA Proposal is without a good basis, and what's more, ignores any effect on GSE missions. Rather, the AAA standard posits that GSE utility, and perhaps even survival, would depend solely on the evaluations from time to time of a private rating agency without any published standards for meeting its highest credit rating. A GSE's ability simultaneously to meet the test and conduct its public mission would be pure coincidence.

1. LOSS OF LIQUIDITY

The AAA standard, whatever its criteria, can be expected to require higher capital ratios, achieved either by shrinking support for the primary market or boosting retained earnings by increasing fees. Either would reduce mortgage market liquidity.

Rating agencies have said they will not provide a "road map to the AAA rating" for those entities that currently would not receive one without federal backing. Certainly, a substantial amount of added capital would be required. But the OMB/Treasury Proposal's limits and restraints (dividend and growth caps, other business restraints to be unilaterally invoked by Treasury) would make it essentially impossible to raise equity by selling stock. Therefore, any "business plan" would require Fannie Mae to shut down operations and shrink drastically.

Thus, the Proposal would shock the housing markets at a time when other factors are already making the condition of housing lenders shaky. It could provoke a housing credit crunch. The reason there has been no mortgage credit crunch this year is because Congress created, in Fannie Mae and Freddie Mac, a system that works. We go into the domestic and world financial markets and compete on behalf of American home buyers and renters for the credit they need for housing.

Federal Reserve chairman Alan Greenspan made exactly this point in his testimony June 21 before the Senate Banking Committee: "The continued flow of credit in residential mortgage markets probably owes much to the many alternatives to depository credit. The securitization of home mortgages has become a routine financial transaction, with about $1 trillion in mortgage debt held in that form. Buyers of these securities...have stepped in to acquire assets shed by thrifts and to fund new lending."

2. LOSS OF STABILITY

The secondary market GSEs were pivotal in stabilizing housing credit flows during the last decade of unprecedented change and turbulence. The turbulence continues, and imposing the OMB/Treasury scheme would cause the "federalization" of more healthy banks and thrifts at taxpayer expense. No "five year plan" in 1985 could have foreseen that in 1990 banks and thrifts would need Fannie Mae and Freddie Mac as mortgage outlets to assist the depository institutions in adjusting to the new risk-based capital rules and FIRREA's impact. And no forecast today can predict how Fannie Mae and Freddie Mac will be needed to accommodate the vast changes that are continuing in financial markets. Without reliable support from the housing GSEs to buy and securitize bank and thrift mortgage assets, those assets will fall in value. More banks and thrifts will end up on the government's doorstep, and RTC liquidation costs will increase as well.

Added to this, the "remedies" for failing the AAA test in the OMB/Treasury Proposal would remove certain federal agency attributes for new debt and MBS. That would affect the future business of depository institutions and could traumatize the financial markets. Depository institutions and the RTC could see more losses in their investment in GSE securities because of severely reduced liquidity of their securities. Fannie Mae securities investment alone by RTC and depositories totals more than $100 billion. Just including the Proposal in the "summit" agreement could well diminish substantially the value of these holdings and add to thrift rescue costs.

3. LOSS OF NATIONWIDE SUPPORT FOR HOUSING IN HARD TIMES

The AAA rating requirement, based solely on financial risk at any given time, could harshly penalize Fannie Mae and Freddie Mac for serving housing markets experiencing hard times, such as the Southwest in the mid-1980s. Continuous market presence when other companies pull out is one of the very reasons Congress chartered the GSEs. It could not be continued if it would jeopardize maintaining the AAA.

4. LOW AND MODERATE INCOME BORROWERS SHUT OUT

The Proposal will penalize the GSEs' efforts to help low-income families afford housing. GSEs straitjacketed by rating targets and growth limits will "flee to quality". AAA GSEs will pursue only gold-plated product -- fixed-rate loans with initial equity of at least 20%. That is surely not what Congress intended when it created Fannie Mae and Freddie Mac.

5. MORTGAGE CREDIT MORE COSTLY FOR ALL

Assuring a reliable supply of affordable mortgage credit will be unattainable with AAA-rated housing GSEs. Lenders, realtors, home builders and consumers all will feel the effects of the inevitable reduced presence of these entities or their higher fees. The result will be reduced and more expensive mortgage credit. Based on periods in the 1980s during which there was a significant shortfall of mortgage credit, mortgage rates would likely rise by 150-200 basis points as a result of the OMB/Treasury Proposal becoming law.

C. NO COST BENEFIT ANALYSIS OF USING AAA VERSUS ALTERNATIVE CAPITAL TESTS.

So far, Treasury and OMB have offered no evidence to demonstrate that the marginal added safety of the AAA rating makes sense, given its potentially enormous social costs.

The AAA Proposal has no precedent in federally supported programs. Nor is there any system of federal laws that invites a regulator to close a business down that is by definition strong and healthy. Thus, the OMB/Treasury Proposal would give Treasury sweeping discretion to hobble Fannie Mae's operations merely because the company was operating at a capital/credit level that fell only slightly below the very highest rating possible.

Currently, no thrifts and only one money center commercial bank have secured the AAA rating from two rating agencies. Yet no one has suggested that these entities, with over $2.6 trillion in deposits insured by the taxpayers, should suffer added business constraints because they fall short of the AAA standard.

And after studying recent FHA losses, the Administration did not recommend that FHA accumulate capital to meet the AAA standard. Rather, it supported, and the Senate approved, reforms expressly designed to balance competing goals: assuring fiscal strength while preserving FHA's ability to assume the inherent risks of financing homes for lower-income buyers.

The data that does exist shows that taxpayers would get precious little for the AAA in a relative sense. A Moody's report issued in April 1990 analyzed default patterns of over 3,000 companies, accounting for almost all long-term corporate debt in the U.S. The study showed that moving from a speculative to an investment grade, and even from Baa to A, meant a significant decline in the default rate. But the increased safety in going from A to AAA was negligible. The respective default rates were AAA: 1.7 percent; AA: 1.9 percent; and A: 2.4 percent. These were defaults, not liquidations and imply a much lower percentage of investor losses.

D. NO EXPLANATION OF WHAT THE AAA REALLY REQUIRES AND HOW CONFLICTS BETWEEN IT AND PUBLIC PURPOSES WILL BE RESOLVED.

The rating agencies have never published concrete criteria for their rating categories. Even more confusing, the AAA Proposal would ask the rating agencies to rate a purely mythical creature -- a GSE without any federal attributes.

Precedents suggest that GSEs, as undiversified entities, may not be able to qualify for the AAA regardless of their capital ratios. Given the government-mandated business restraints imposed on the housing GSEs, how will the government assure that the rating agencies' methods and assumptions reflect those public policy considerations deemed critical by the government? Does this mandate a regulator for the rating agencies? In a similar vein, how will the supervisory function of the government interact with the rating agency function, and how will major differences be reconciled if they arise?

How can so complicated an issue be resolved without informed and careful consideration?

E. ADDING USER FEES TO THE AAA IS LETHAL.

What conceivable benefits to GSE strength or to budget summitry would flow from adding user fees to the blend of higher capital and volume caps as OMB would add to the OMB/Treasury Proposal? The Proposal requires the GSEs to meet rash and ill-conceived capital standards and OMB would add a siphoning of potential capital into general federal revenues. This would set up a vicious circle in which the likely result is total federalization of GSE debt and MBS -- with dire consequences for the financial markets within which GSEs operate.

Summary

Fannie Mae offers unqualified support for the goals of responsible capital, strong credit and effective supervision of the housing GSEs. But the timing and content of the OMB/Treasury's AAA Proposals bear only the most specious nexus to these principles.

The AAA rating test renders the concept of "continued GSE benefits" an oxymoron. All the evidence shows that the AAA rating will in all likelihood require Fannie Mae and Freddie Mac to forgo the normal business risks attendant in their public mission.

The nation cannot afford to risk abrupt, unnecessary changes in already fragile markets. It would certainly be a pyrrhic victory if the summit "solved" a non-existent "problem" on an ill-considered "emergency basis" by imposing ill-conceived requirements on Fannie Mae and Freddie Mac that would cause substantial disruption of the housing and mortgage finance markets and the general economy.

We urge the Congress to reject these measures, and to take the time and care to test the merits of a very complex set of issues. Fannie Mae and Freddie Mac play an enormously vital role in financial markets and public policy. This is not the time to roll the dice and threaten our future.

SENATE COMMITTEE
ON
BANKING, HOUSING AND URBAN AFFAIRS

SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS

Testimony of
Allan Hunt, Executive Director
Vermont Housing Finance Agency
on
The Activities of FNMA and FHLMC

on Behalf of
the
National Council of State Housing Agencies

August 2, 1990

Testimony of Allan Hunt, Executive Director, Vermont Housing Finance Agency on Behalf of the National Council of State Housing Agencies Before the Housing and Urban Affairs Subcommittee Senate Committee on Banking, Housing and Urban Affairs

August 2, 1990

Chairman Cranston, Senator D'Amato, and members of the Subcommittee, my name is Allan Hunt and I am Executive Director of the Vermont Housing Finance Agency (VHFA). I am here this morning on behalf of the National Council of State Housing Agencies (NCSHA) which represents the housing finance agencies (HFAs) of the fifty states.

We appreciate the opportunity to comment on the activities of the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC), particularly in the area of low and moderate income housing. A number of NCSHA's member agencies, including VHFA, have partnered with these important secondary market institutions to provide housing for low and moderate income individuals and families across the country. We have a strong stake in their continued financial strength and commitment to affordable housing.

I will be making two key points in my testimony:

- Congress has entrusted FNMA and FHLMC with the responsibility to assure the availability of mortgage capital to low and moderate income homebuyers. They are crucial to these markets. At a time of severe affordability problems for the very buyers FNMA and FHLMC are intended to serve, they should be encouraged to do more, not constrained to do less, to increase low and moderate income housing opportunities.
- Any measures to ensure FNMA's and FHLMC's safety and soundness must be carefully balanced with the need to preserve their Congressionally-mandated public purpose. HUD's, Treasury's and the President's oversight authority should be exercised not only to assure safety and soundness, consistent with FNMA's and FHLMC's public purpose, but also to encourage them to make a greater effort toward expanding and mainstreaming their lending programs for low and moderate income housing.

NCSHA is a national, not-for-profit organization created in 1970 to represent the interests of State HFAs in low and moderate income housing. HFAs in every state, the District of Columbia, Puerto Rico, and the Virgin Islands respond to low and moderate income housing needs through the financing, development, and preservation of affordable ownership and rental housing. HFAs collectively operate more than 350 affordable housing programs, which range from homeownership to homeless initiatives.

State HFAs have helped more than 1,000,000 low and moderate income Americans buy their first home through MRB programs which they administer in every state. These HFAs issued approximately $6 billion in MRBs in 1989 under the private activity bond cap which strictly limits the overall volume of such bonds. In 19 states, these HFAs also operate Mortgage Credit Certificate (MCC) programs.

NCSHA's member HFAs have also financed over 500,000 units of rental housing for low and moderate income tenants through reduced interest rate mortgages financed by tax-exempt bonds. Since 1986, NCSHA members have financed 235,000 low income rental units with the Low-Income Housing Tax Credit (Tax Credit) for households with incomes at 60 percent or less of area median.

The MRB program, the only generally available federal mortgage assistance program in today's disheartening environment of climbing home prices and declining homeownership rates, is scheduled to expire on September 30 of this year. An overwhelming 85 percent majority of the Congress -- 455 of the 535 House and Senate members, including 70 percent of the members of both tax-writing committees -- have co-sponsored legislation in this Congress to extend this time-honored, well-tested, and Congressionally limited program to make the national goal of homeownership attainable by lower income Americans. We urge the Congress to support a permanent MRB extension in this year's Budget Reconciliation bill. Similarly, we encourage your support for a permanent extension of the Tax Credit, the major federal stimulus of low income rental housing production nationally, which terminates at the end of this year.

Existing Federal Oversight of FNMA, FHLMC

In establishing FNMA as a government-sponsored private corporation in 1968, the Congress assigned it two primary missions: (l) to maintain a viable secondary market which would make mortgage capital available to all areas of the nation, and (2) to ensure the availability of mortgage capital to low and moderate income families to purchase homes.

FNMA has more than fulfilled the first purpose, financing one out of every seven homes in the United States. By creating a secondary market for 3,000 lenders, FNMA ensures the continuing availability of mortgage funds to the communities served by those lenders. Without this secondary market, lenders would be forced to limit their residential lending according to their size, and now with increased capital requirements, this availability would be even further restricted for loans kept in portfolio.

FNMA is aggressively working toward the accomplishment of its second mission, expanding housing opportunities for low and moderate income households. Further efforts in this area are crucial.

To ensure that these public purposes could be realized, Congress conferred certain benefits upon FNMA which are not available to the private sector such as exemption from SEC regulation and state taxes. To make sure that these purposes were realized, Congress gave HUD, the Treasury and the Executive Branch significant regulatory authority over the agency.

HUD's current oversight and regulatory authority over FNMA is extensive. The HUD Secretary must approve FNMA's issuance of stock, obligations, securities, or other instruments and its purchase, servicing, sale, or lending on the security of conventional mortgages. In addition, the Secretary must sign off on the amount of nonrefundable capital contributions required of each mortgage seller and the stock retention requirements imposed on each servicer of its mortgages. FNMA may not allow the obligations of the Corporation to exceed 15 times the sum of its capital, capital surplus, general surplus, reserves, and undistributed earnings without Secretary approval. The Secretary must approve the payment of cash dividends to shareholders and can only approve such payments if they do not exceed what the Secretary determines is a fair rate of return.

In addition to HUD's authority, the Secretary of Treasury since 1986 has exercised total control over the maturity and rate of interest of FNMA's obligations and FNMA's access to the capital markets. Finally, the President has control over the appointment of five public members to the 15 member Board of Directors and the power to remove both the Presidential appointees and the ten private members elected by shareholders for "good cause."

Proposals such as those advanced by the Treasury and OMB to tighten FNMA's capital reserve and borrowing requirements would endanger FNMA's public purpose and frustrate Congressional intent, as expressed in FNMA's 1968 Charter. To ensure that FNMA's activities do not create unreasonable risks for the government and serve the public purpose for which FNMA was created, HUD need only exercise its existing regulatory authority. HUD's recommendations to improve its regulation of FNMA and to undertake the regulation of FHLMC (as required under FIRREA) contained in its June, 1990 Report to Congress would be positive steps.

The analogy between FNMA and FHLMC and banks is not a fair one. Banks have not been subject to the close scrutiny and regulatory control which has been imposed upon FNMA and FHLMC and in fact, have operated in a deregulated environment. FIRREA legislation has only recently brought banks onto the same regulated playing field. Capital requirements recently imposed on banks were necessary partly because of the risks and losses of those institutions in areas other than residential lending. FNMA/FHLMC investments do not include the more risky merchant loans, commercially secured loans and risky securities investments which caused great losses to private lending institutions. Not only have private lenders not been subject to the kind of regulation which FNMA/FHLMC have had, they have also not been subjected to scrutiny by the business community, bond holders and shareholders.

To achieve a AAA credit rating, lending restrictions would have to be imposed on FNMA and FHLMC business which would preclude the additional risk necessitated in serving low and moderate income housing needs. Such action would lead to the elimination of FNMA's and FHLMC's low and moderate income lending initiatives in place for only the past few years, and the drastic contraction of their secondary market activities in conventional areas.

Most important, the impact of increased capital adequacy requirements on FNMA's public purpose mandate was not addressed by the Treasury report. Certainly, no action should be taken without a full study of this issue. It appears that the Treasury seeks self-protection by one arm of the government which would undoubtedly undermine, if not destroy, the intention of Congress in chartering FNMA and FHLMC as government-sponsored private institutions to maintain a secondary market which makes housing affordable for low and moderate income Americans.

Increased public accountability, however, to ensure FNMA's and FHLMC's fulfillment of their mandate to provide housing to this sector is warranted. For example, FNMA and FHLMC should set forth aggressive low and moderate income performance standards. HUD oversight could ensure that this mission is not compromised by an overzealous effort to achieve fiscal soundness through risk aversion. Efficient, effective and profitable mortgage lending is accomplished through risk management not risk avoidance.

FNMA and FHLMC Are Important Partners with HFAs in Affordable Housing

In this regulatory environment, FNMA and FHLMC have not only remained solvent but have thrived, and in fact, FNMA has expanded its programs deeper into the service of low and moderate income lending.

In 1987, FNMA made a commitment to increase its efforts on behalf of low and moderate income families through the creation of its Office of Low and Moderate Income Housing. By the end of 1989, this office had made commitments to invest nearly $3.5 billion to help finance housing for more than 70,000 low and moderate income households through public finance programs, community lending programs and low-income rental housing equity investments. FNMA now offers a number of products designed to reduce state and local agencies' cost of borrowing, making it possible for agencies to enhance housing affordability.

Since 1987, FNMA has purchased MRBs issued by both state and local housing agencies to fund single family mortgages. As of February, 1990, these purchases totaled $2.2 billion in bonds from twelve states to provide below-market mortgage financing for approximately 37,000 first-time homebuyers. By selling bonds directly to FNMA, agencies can reduce their issuance costs and consequently can make mortgages available at lower interest rates and with lower closing costs than would otherwise be possible. Recent purchases have included set-asides for borrowers with incomes at and below 80 percent of area median income. This program poses virtually no risk for FNMA since the bonds are backed by GNMA securities, and earns a healthy return. It already accounts for over half of the low and moderate income families served by FNMA programs as well as half of the corporation's $3.5 billion dollar investment in low and moderate income housing. We would like to see it expanded.

FNMA has also purchased the bulk of HFA loans made with Mortgage Credit Certificates (MCCs). As of 1989, 18,000 loans had been made with MCCs in 16 states.

Our agencies are also working with FNMA to move government-owned, foreclosed properties into the hands of low income people. FNMA's private placement program offers below-market interest rates for the acquisition and rehabilitation of real estate owned properties. Just last month, FNMA agreed to purchase $93 million of $140 million in MRBs purchased by the Resolution Trust Corporation (RTC) to finance more than 2,000 RTC-owned single family homes for low and moderate income homebuyers in Texas.

State HFAs also rely on FNMA for credit enhancement for bonds issued to finance both homeownership and rental housing units. FNMA assures the payment of principal and interest on the bonds either through the issuance of mortgage-backed securities or the pledging of mortgage collateral from its portfolio. This enables agencies to issue bonds with a more attractive credit rating, thereby reducing their borrowing costs and permitting participating lenders to originate mortgages at lower interest rates. In California, Kentucky and Georgia, single family credit enhancement transactions have resulted in the below-market financing of 1,800 homes for low and moderate income families. FNMA is working with our agencies in 27 states to provide credit enhancement for multifamily projects. We look forward to stepped up FNMA activity in the credit enhancement area.

FNMA has also provided needed access to the secondary market for nonconforming mortgage loans. The Vermont Housing Finance Agency (VHFA) has teamed up with FNMA to package and sell mortgage-backed securities pooled from residential, fixed-rate loans with nonconforming aspects which made them unacceptable to the national secondary mortgage market. Under the Green Mountain Mortgage Market, or "Sugar Mae" venture, VHFA will purchase up to $100 million of these mortgages and aggregate them into pools for mortgage-backed securities (MBS). FNMA will guarantee the securities and ensure timely payment of principal and interest. FNMA's MBS are considered "triple A quality." VHFA will sell the MBS to investors at close to market rates and act as master servicer for the collateral mortgages. Participating lenders will reinvest at least 50 percent of the proceeds from the sale of their loans in activities that support the housing needs of low and moderate income Vermonters. Sugar Mae's first commitment was a $6.1 million MBS sale to a Vermont pension fund.

Under the Delegated Underwriting and Servicing producer line, high quality lenders can obtain special approval to underwrite and sell to FNMA new multifamily loans without prior review. Mortgages on existing and recently completed properties and on properties to be moderately rehabilitated are eligible. In exchange for the faster and easier processing and favorable pricing provided by the program, lenders share any losses with FNMA according to a predetermined formula. Fifteen State HFAs, including VHFA, are approved single family FNMA seller/servicers. In addition, New Hampshire and North Carolina have expressed interest in becoming seller/servicers. The states approved as multifamily seller/servicers are Pennsylvania, Vermont and Massachusetts. We feel that this program could be even more beneficial if its qualification standards were revised to better address the needs of the organizations which use it.

Less State HFA activity has occurred with FHLMC, but we are encouraged that this will change with the creation of FHLMC's Affordable Housing Initiatives Department. We hope to see more of what FHLMC is doing with the Michigan State Housing Development Authority, from whom FHLMC has agreed to purchase $500 million in mortgages originated under a public/private partnership. By modifying underwriting and servicing guidelines, providing homebuyer education and counseling, sharing credit risk, and involving community groups, more than 10,000 Michigan families will have access to financing that would not otherwise have been available to them.

In addition, FHLMC and FNMA have made investments in equity pools and in HFA assisted projects. Tax credits have been purchased in several states including Michigan, Massachusetts, Rhode Island, Washington, New Mexico, Maryland, Missouri, Vermont, and D.C. These investments have earned FNMA exceedingly high returns. The corporation's desire to avert risk, however, in some cases has led to higher project costs and more complicated transactions. Improvements to this program should take the form of simpler underwriting standards and partnership agreements as well as lower required rates of return.

Improvements Needed In FNMA, FHLMC Affordable Housing Operations

Some improvements in addition to those noted above are needed in FNMA's and FHLMC's low and moderate income lending programs. The development, coordination and administration of financing techniques with FNMA and FHLMC has often been time-consuming and challenging because few within the credit decision-making bodies of these agencies have a sufficient level of familiarity with standard mortgage banking practices, coupled with the nuances of public policy and low income housing issues.

More balanced risk analysis is essential in evaluating "standard requirements" established for conventional lending programs against factors which reduce risk to state agencies, such as full recourse, strong financial structure, top tier status with ratings agencies, deeper primary insurance coverage, pool insurance and recognition that HFAs, unlike most private lenders, are subject to increased public scrutiny as well as that of their bond counsel and rating agencies.

To achieve a more efficient and effective administration of FNMA's and FHLMC's public purpose objectives in partnership with HFAs, we recommend that representatives of the public finance industry be appointed to the credit policy committee of each, and be appointed to each of their regional advisory boards. These representatives could work to ensure that FNMA and FHLMC dovetail their programs with existing HFA programs to provide and preserve affordable housing.

We also recommend that FNMA and FHLMC continue to identify staff with experience in low income housing finance. Low-income housing initiatives groups should be formed with representatives from each relevant office or department having sign-off. Specific individuals in the central offices should be designated to evaluate all low-income proposals so that they may develop knowledge and expertise in this area. Industry input should be sought through the creation of low and moderate income housing advisory committees, perhaps commissioned by HUD.

Congress in the 1968 charter required only that FNMA make a "reasonable" contribution to low and moderate income housing. The lack of definition of or scrutiny of this mandate has resulted in much less of a contribution to low and moderate income housing needs than has been necessary to fulfill their fiduciary responsibility. A definition of low and moderate income should be developed which coincides with that of Congressional and IRS definitions, not to exceed 115 percent of area median income. Currently, FNMA and FHLMC are silent on the definition of income, depending on mortgage limits to fulfill this objective. This is ineffective because the purchase price of a home does not necessarily correlate to the income level of a purchaser. It is a passive, rather than an active, approach toward defining their markets. In fact, FNMA's current relatively high average balance on current loan purchases suggests that FNMA may be serving the middle and upper reaches of the market more effectively than the low to middle sector.

FNMA and FHLMC need to work closely with HFAs to develop new products and financing techniques which can approximate the benefits offered by tax-exempt financing, especially those products which have already been tested and proved by public entities. For instance, silent second mortgages (which have been offered by several HFAs for some time) provide a safe, sound and wise investment which return a healthy profit to the provider, at the same time they achieve the same or greater benefit for a homeowner as achieved through tax-exempt rates. Further, unlike most conventional secondary financing, second mortgages do not increase the risk of default on a borrower's first mortgage. We strongly recommend that FNMA and FHLMC, as long-term market players, provide a long-term investment source for this uniquely effective form of financing.

While FNMA contributed enormously to the development of a secondary marketable reverse annuity mortgage product through its participation in the Home Equity Conversion Mortgage (HECM) program, this needs to be taken to the next step to develop more reverse annuity mortgage products, with and without FHA insurance, which more effectively address the homeownership needs of senior citizens. For instance, several HFAs have for some time offered their constituencies a reverse annuity mortgage which does not have the constraints and added cost to borrowers who can least afford it of mortgage insurance, but which at the same time poses little risk of loss to the investor. Expanding on the experience and expertise which now exists within the public finance arena, FNMA could continue its initiative in this area with or without Congressional expansion of the HECM program.

FNMA holds in its portfolio a sizable number of existing HUD-insured project mortgages and, as owner of these mortgages, has enormous potential to influence and direct the outcome of the prepayment crisis. To give substance to their concern about expiring-use properties that are at risk of loss from the low income housing inventory, FNMA and FHLMC should put a simple, inexpensive program in place to refinance loans on projects at risk.

For apartment buildings serving lower-income tenants, there is still no standard secondary market loan program offered. For low and moderate income rental projects, FNMA and FHLMC should offer a simpler, more flexible multifamily product like the one used in FNMA's pilot program with the Low Income Housing Fund of San Francisco. FNMA has made few purchases of multifamily loans with community-based nonprofit borrowers; many smaller projects have been submitted to FNMA, but loans under $1 million are discouraged and upfront fees are high, as are debt service coverage and insurance requirements.

Conclusion

Once again, we must reaffirm our commitment to meet America's housing needs. Over fifty years ago, we created a secondary market that made homeownership more than a dream, but reality for many people. Twenty years ago, we privatized this effort to incorporate all the efficiencies of the private sector.

Today, we reassess this experiment which has exceeded all expectations and is working, and we ask ourselves: Could it work better? More specifically, have FNMA and FHLMC met the needs of low and moderate income families? The answer is yes -- in some cases and at some times. The success stories have been widely publicized, but we need more of them.

We must review these organizations not strictly as merchants of debt, but more critically, as agents for low and moderate income homeownership. These organizations provide access to mortgage capital that is as important today as it was fifty years ago. The credit crunch alone necessitates the existence of FNMA and FHLMC. If we set credit standards for FNMA and FHLMC based on third party reviews, we are abnegating public responsibilities. Without such third party reviews, FNMA and FHLMC have been instrumental in making mortgages available to working families. Will third party standards enhance that goal? No. On the contrary, if we raise credit standards, we undermine our service to those families. To cite a truism, we shouldn't fix what isn't broken.

To paraphrase one of our newer allies,

> Organizations are never merely a product of the world around them, they are always capable of striving for something better.

Let us push FNMA and FHLMC. Let us poke, but let us not shackle them.

Testimony of

Peter J. Blampied
President and Chief Executive Officer
The Boston Five Cents Savings Bank, FSB

on behalf of

The National Council of Savings Institutions

before the

Subcommittee on Housing and Urban Affairs

of the

Committee on Banking, Housing and Urban Affairs
United States Senate

August 2, 1990

Testimony of
Peter J. Blampied
President and Chief Executive Officer
The Boston Five Cents Savings Bank, FSB
on behalf of
The National Council of Savings Institutions
before the
Subcommittee on Housing and Urban Affairs
of the
Committee on Banking, Housing and Urban Affairs
United States Senate
August 2, 1990

Mr. Chairman, my name is Peter J. Blampied and I am President and Chief Executive Officer of The Boston Five Cents Savings Bank, FSB. I am also a member of the Board of Directors of the National Council of Savings Institutions. I am appearing today to present the views of the National Council on the role of and possible financial risks associated with the federally sponsored secondary mortgage market agencies, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).

The hearings today are timely in view of the changes in the marketplace as the mortgage industry reacts to the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), and in view of current discussions in the budget summit between leaders of Congress and the Administration that could result in significant changes to the operations of Fannie Mae and Freddie Mac.

Today's news is dominated by depressing statistics about falling real estate values, decreasing housing starts, and skyrocketing estimates of the costs of addressing insolvent institutions taken over by the federal government. Amid this array of disturbing developments comes a proposal by the Treasury Department to require Fannie Mae and Freddie Mac to obtain a triple-A rating absent any implicit government support. This proposal would give Treasury almost total control over Fannie Mae and Freddie Mac if either of them failed to obtain a triple-A rating within three months of enactment of the proposal.

The National Council supports stronger capital. We supported the increased capital requirements for savings institutions in FIRREA, and we support strong capital for Fannie Mae and Freddie Mac. The Treasury proposal however, goes well beyond establishing adequate capital levels for quasi-governmental agencies.

This new Treasury proposal, unveiled only two months ago, is de-facto privatization of these agencies, a goal sought by the previous Administration for years. After extensive hearings and consideration of privatization, the idea was rejected. In large part, the approach was rejected because a workable scheme could not be presented by the Administration.

This new Treasury proposal offers a twist on an old idea, that is, to keep the federal ties in place, but to preclude Fannie Mae and Freddie Mac from taking them into account when pricing their goods and services. This proposal has had relatively little scrutiny, yet is under serious discussion in the budget summit.

The view of the National Council is that, if enacted, the Treasury proposal could increase the cost of homeownership for millions of Americans, precipitate a mortgage credit crunch, further depress already weak real estate markets, and, most importantly, increase the cost of FIRREA to taxpayers.

Now is not the time to enact sweeping, fundamental changes to the operations of Fannie Mae and Freddie Mac. The Treasury report announcing this proposal states that the current capital levels of Fannie Mae and Freddie Mac do not pose an imminent threat. There is time to assess fully any changes to the agencies' charters.

Now is not the time to try bold new experiments due to: the unstable condition of many financial institutions, including savings institutions, commercial banks, and insurance companies; the weakness of major real estate markets across the country; the mammoth challenge facing the Resolution Trust Corporation and the FDIC; and the rapid increase in the federal budget deficit over recent months.

The Department of Housing and Urban Development (HUD) is working to enhance its capability to regulate Fannie Mae and Freddie Mac. HUD is conducting in-depth reviews of the agencies and formulating sophisticated new ways to monitor their capital positions, the risk they pose to the federal government, and their ability to fulfill their charter obligations.

I will now cover in greater detail the issues you raised in your letter of invitation to testify today. But first, it is important to review the changes to the mortgage marketplace that have taken place since the passage of FIRREA, and the health of that market.

Recent Changes of FIRREA and Risk-Based Capital Rules on Mortgage Finance--Increased Importance of the Agencies

FIRREA's effects on mortgage markets, including secondary markets, are significant and still developing. When FIRREA's rules are laid over the new approach embodied by risk-based capital guidelines, the changes to the mortgage landscape are even greater. Due in large part to more stringent capital requirements and risk-based capital rules, depository institutions are less willing to fund mortgage acquisitions through insured deposits. Agency securities have assumed even more importance to depository institutions that are active in their housing markets.

New capital guidelines require that many institutions shrink in order to attempt to meet tougher new capital rules. The National Council supports these higher capital requirements. It is not surprising that the most recent data from the Office of Thrift Supervision shows that savings institutions decreased their assets by 8 percent in February 1990 from the previous year.

However, as marginal institutions shrink to bolster their capital positions, and healthy institutions work to ensure that they will have even more capital, all institutions operating today are less willing to put new loans in their portfolios. Therefore, increased emphasis on capital, while correct, provides a negative incentive for thrifts to originate any loans they cannot immediately sell in the secondary markets.

If a loan is to be held in portfolio, risk-based capital rules provide additional negative treatment for loans that cannot be converted to Fannie Mae or Freddie Mac securities. This is because mortgages have a risk-weighting of 50 percent, while loans swapped with Fannie Mae or Freddie Mac for mortgage securities have only a 20 percent risk weighting. Therefore, an institution would have to set aside 2.5 times more capital to buttress a residential loan than a mortgage security from either of the two secondary market agencies.

Weak Real Estate Markets

The Administration's FY 91 budget notes that "federal housing credit programs worked well in the environment of rising house prices and low interest rates that characterized much of the post-World War II period. Since 1980, market conditions have not been as favorable to guarantors of mortgage credit. This trend will probably continue." In addition, the budget states that "fewer people will be entering their home buying years in the next two decades. Reduced demand may slow the increase in housing prices. Mortgage default rates tend to rise when appreciation slows, increasing federal mortgage insurance losses."

However, the Treasury report on GSEs (Government-sponsored enterprises) issued in May 1990 modified this assessment somewhat by stating, "the growth of the 35 to 64 year olds will accelerate, resulting in a larger trade up market... In addition, it is forecast that the demand for replacement homes will increase as the stock of homes built prior to World War II (almost 25 percent of the total) continues to age. Thus, move-up demand is expected to combine with increased replacement demand to partially offset the onset of the 'baby bust' generation."

In any case, the short-term housing outlook is decidedly gloomy. Paul Fritts, Director of the FDIC's Enforcement Division, testified at a June 21, 1990, Senate Banking Committee hearing on the so-called credit crunch in New England that "real estate markets are weakening not just in New England but across many parts of the country. As of year-end 1989, there were 20 states where banks had noncurrent real estate loans that exceeded two percent of total real estate loans. Only three months later, our first quarter data shows 28 states where the percentage of noncurrent real estate loans exceeds two percent. More than half these states have a noncurrent ratio of three percent or higher."

The Liquidity Function of the Agencies--Avoiding a Mortgage Credit Crunch

Perhaps the most critical function of the agencies in today's environment is bringing liquidity to a fragile real estate market. In light of emerging signs of a weakening real estate economy, we are concerned that a precipitous reduction in the ability of Fannie Mae and Freddie Mac to support mortgage markets as outlined in their charters could make a bad situation worse.

While FIRREA and risk-based capital rules have created scarce funds for construction, commercial, and other forms of lending, the agencies have worked to ensure that residential credit has been available. Federal Reserve Board Chairman Alan Greenspan made this point in the same Senate Banking Committee hearing on June 21, 1990. Chairman Greenspan noted that, "The continued flow of credit in residential mortgage markets probably owes to the many alternatives to depository credit. The securitization of home mortgages has become a routine financial transaction, with about $1 trillion in mortgage debt held in that form. Buyers of these securities, such as pension funds, insurance companies, and mutual funds, have stepped in to acquire assets shed by thrifts and to fund new lending." Without the participation of the agencies (which back over 95 percent of mortgage securities), this investor diversification and availability of credit would not be possible.

Assuming that both Fannie Mae and Freddie Mac could not now garner a triple-A rating from a private rating company, they would have to react as any financial institution would in similar circumstances. Paul Fritts outlined what this response might be before the Senate Banking Committee. Fritts said, "In order to maintain compliance with capital requirements, many affected banks found it necessary to retrench through a shrinkage in size. This is not an uncommon scenario under the circumstances. As a result, there has been a general contraction in the availability of credit funds in these institutions."

This tightening of mortgage credit would increase mortgage costs and further depress real estate prices. This would increase delinquencies, push more institutions over the brink, increase the workload and real estate holdings of the RTC and FDIC, and, ultimately increase the taxpayer cost of funding the work of the RTC.

The Secondary Markets and Savings Institutions

While deposit insurance has run into significant problems, government mortgage securities have experienced significant growth and innovation. The Administration's FY 91 budget message refers to this change and points to its incursion on the traditional, deposit insurance-supported institutions. "GSEs were innovators -- they developed multi-class mortgage-backed securities to tap global capital markets. Broadening the range of mortgage investors reduced the cost of mortgage credit to the borrower. But lower mortgage rates also squeezed the profit margins of traditional mortgage lenders, adding to the difficulties already faced by savings and loans."

The profit margin squeeze being experienced by many savings institutions has been caused in part by the greater efficiency and competition represented by the secondary market agencies. At The Boston Five, we have recognized this as reality and have adjusted our approach to the markets to enable us to serve the mortgage needs of our community without exposing our institution to significant interest rate risk.

It is the position of the National Council that the secondary market agencies present important opportunities for savings institutions to operate in today's statutory and interest rate environment. As mentioned earlier, the agencies help savings institutions to meet the new capital rules as established by FIRREA.

The seeds of the savings and loan disaster of 1989 were sown in the late 70s and early 80s when the industry was bankrupted by interest rate mismatches of underwater loans funded by high interest funds. Fannie Mae and Freddie Mac offer savings institutions the opportunity to generate fee income by originating and servicing mortgages. This approach exposes the institution to relatively little long-term interest rate risk.

The secondary market agencies also enable savings institutions to improve the management of their interest rate risk exposure. Institutions can use agency securities in a variety of capital-raising techniques, such as repurchase agreements, dollar rolls, and mortgage-backed bonds. These offer institutions efficient and safe financing options that otherwise would not be available.

The agencies also provide important options for savings institutions as they attempt to meet requirements established by the Community Reinvestment Act. The agencies, and Fannie Mae in particular, have developed programs for affordable housing in which savings institutions can participate. It is often quite a daunting task for an individual institution to create its own localized CRA program, and the agencies offer the possibility of an already-developed program that can be applied in that institution's market.

If the activities of the secondary market agencies were disrupted dramatically, it is likely that mortgage rates would rise as the so-called "agency" spreads would expand. This would be good news to savings institutions in the sense that spreads on new loans put into their portfolios would be greater. On the other hand, higher interest rates on new mortgages would tend to drive down home prices, which would cause defaults and other loan problems to rise. This could precipitate an increase in loan loss reserves for institutions and generally increase real estate problems in the short term.

HUD's Regulation of the Agencies

The National Council supports the role of HUD as the primary regulator of both Fannie Mae and Freddie Mac. Since Fannie Mae was spun out of government as a private corporation in 1968, HUD has functioned as its primary federal regulator. Clearly HUD has garnered experience in this role, and is best suited to assure that both the agencies meet their housing mandates while maintaining sufficient capital.

By regulating both agencies, HUD can assure that both operate on the so-called "level playing field". In the past, when Freddie Mac was regulated by the Federal Home Loan Bank Board, there were instances when one agency was authorized to do something that the other was not. Under the Treasury proposal, the possibility is raised that one agency would be regulated by Treasury with the other regulated by HUD. This could easily lead to a situation where the agencies are not operating on an even footing, raising serious concerns. The American homebuyer has been well served by having strong competition between the agencies, and keeping HUD as the regulator of both is the best way to assure that this competition continues.

HUD has already made significant changes in upgrading its oversight of the agencies to keep in step with increased concerns over the growth of federal contingent liabilities. The initiatives announced to develop the Financial Institutions Regulatory Board, the Office of Regulatory Functions, and financial models to oversee the agencies risk exposure, indicate that the growth and activities of these agencies can be monitored effectively by a government agency.

It would be possible for HUD to augment its staffing capabilities in this regard. Just as Fannie Mae and Freddie Mac have hired outside firms to assess their capital levels, HUD could also employ outside experts to do the same. While this supplemental expertise could rival that of the rating agencies, all major policy decisions would be made by HUD, a public agency, and not a rating agency, which is a private concern.

In addition, HUD should consider establishing a regular liaison with Wall Street analysts that cover both the equity and debt of the agencies. This would help assure that HUD has the benefit of the Street's latest concerns about the health or direction of the agencies.

HUD is the appropriate agency to oversee the financial and program operations of Fannie Mae and Freddie Mac. These two matters cannot be separated as has been suggested by the Treasury proposal. The capital adequacy and so called "safety and soundness" issues are of paramount importance in determining the operating parameters of the agencies. If the two are separated, you will have, in effect, created two regulators -- one with almost all the power, and the other with relatively little.

Appropriate Capital Levels

In recent months, several efforts have been made in assessing the capital adequacy of Fannie Mae and Freddie Mac. The Treasury Department, the Government Accounting Office, and HUD, have conducted in-depth reviews of the agencies. The reports to date are encouraging. The Administration's FY 91 budget message, the Treasury report on GSEs, a GAO report, and HUD's reports all state that the agencies pose no imminent risk of exposing the federal government to financial loss.

The agencies themselves are acting to assure that their capital levels are adequate. Fannie Mae and Freddie Mac have conducted their own reviews of their capital positions. As a result of it's review, Fannie Mae has unilaterally pledged to increase its capital by $2 to $2.5 billion by the end of next year.

In light of HUD's stated plans to develop the capacity to monitor the agencies' business and risk on an ongoing basis, we believe that there is time to work within the existing regulatory framework to assure that the capital levels of Fannie Mae and Freddie Mac are adequate. HUD is the appropriate agent of the federal government to conduct this dialogue.

As explained in HUD's report on the agencies, one of the methods used to assess the agencies' capital levels was to employ stress tests to see how the agencies would do in times of significant increases in interest rates and or falls in real estate values. Stress tests are valuable tools in gauging the potential risk posed by the agencies. However, these tests should be reasonable. Virtually no firm could survive the extreme stress represented by the upper end of HUD's tests, which called for a 1500 basis point increase in rates for a ten-year period.

The Effects of the Treasury Recommendations

The Treasury proposal begs the question, "Why have agency status, if it must be ignored by the very entity set up to use it to further certain public policy goals?" If the agencies must operate in a way that forces them to maintain a triple-A rating, they will have to price their services as a totally private company in a similar line of business.

One of the major problems facing this nation's residential mortgage markets has been a relative scarcity of long-term capital invested permanently in residential mortgages. Yet, it is safe to assume that if the Treasury proposal is implemented, Fannie Mae and Freddie Mac would be unable to meet their charter responsibilities of supporting residential mortgage markets.

In order to meet the substantial limits that the triple-A rating imposes, the agencies would charge more for and/or limit the following:

--purchases of new mortgages, since new mortgages present higher risk than seasoned ones,

--purchases of loans in excess of 80 percent loan-to-value, since these loans are more risky,

--the development of programs for low- and moderate-income homebuyers that require developing new staffing and areas of expertise, and

--the swapping of loans for securities, thereby increasing the cost of portfolio management for banks and savings institutions active in housing markets.

And when the agencies do achieve a triple-A rating that ignores their ties to the federal government, they would then probably do everything they could to sever those ties. In the end, the government conceivably could lose all control over entities that can provide so much support and stability to such an important sector of our economy.

Conclusion

There is a middle ground between maintaining the current capital position of the agencies and the extreme position represented by the Treasury proposal. The desired goal of the Treasury recommendations, that is, to ensure that the federal government will never be in a position of having to bail out Fannie Mae or Freddie Mac,-can be achieved in other, more practical, and frankly less dangerous ways.

The focus of this hearing is correctly the risk to the federal government posed by Fannie Mae and Freddie Mac. I would like to conclude my remarks by noting that, ironically, it appears that the current single largest risk of major proportions to increased federal credit exposure related to these agencies is represented by the Treasury's recommendations.

UNIVERSITY OF CALIFORNIA, BERKELEY

BERKELEY • DAVIS • IRVINE • LOS ANGELES • RIVERSIDE • SAN DIEGO • SAN FRANCISCO SANTA BARBARA • SANTA CRUZ

Robert H. Edelstein
Co-Chairman

CENTER FOR REAL ESTATE AND URBAN ECONOMICS
2680 BANCROFT WAY, SUITE A
BERKELEY, CALIFORNIA 94720
(415) 643 - 6105
FAX: (415) 643 - 7357

September 7, 1990

Mr. Edward M. Malan
Senate Committee on Banking, Housing, and Urban Affairs
Room SD 534, Dirksen Senate Office Building
Washington, D.C. 20510

RE: "Corrected" Statement
August 2, Testimony

Dear Mr. Malan:

Please find enclosed a "corrected" version of my Statement for the August 2, 1990 Hearings. These materials supersede the earlier version; I am sorry for any inconvenience this may cause.

Sincerely,

Robert H. Edelstein

Robert H. Edelstein

RHE:hf
Encl.

Statement of Robert H. Edelstein

Real Estate Development Professor,
Chair, Real Estate Faculty Group,
Co-Chairman, Center for Real Estate and Urban Economics,
Walter A. Haas School of Business,
University of California at Berkeley

Before the United States Senate,
Committee on Banking, Housing, and Urban Affairs
Sub-Committee on Housing and Urban Affairs

Round Table Hearing On
HUD's Report on the Safety and Soundness of Fannie Mae and Freddie Mac
Thursday, August 2, 1990

Mr. Chairman, and Members of the Sub-Committee:

I thank you for the opportunity to come before your Committee to review the two recent HUD Reports on the current and prospective conditions of Fannie Mae[1] and Freddie Mac[2]. I will present a brief summary of my opinion about these reports below. My comments will then focus upon the viability of the recent proposals by the Department of Treasury (Treasury) and the Office of Management and Budget (OMB) for regulating Government-Sponsored Enterprises (GSE). My discussion below will examine the effects and evaluate the merits of these proposals as they pertain to Fannie Mae and Freddie Mac.

HUD Reports on Fannie Mae and Freddie Mac

In brief, the HUD Reports to Congress on the conditions of Fannie Mae and Freddie Mac are sophisticated analyses of each entity, are accurate representations of the factual circumstances, generate forecasts of future fiscal conditions, and provide an exceptionally even-handed, non-partisan overview. The analyses incisively portray the risk confronted by the Federal Government by its quasi-guarantees of Fannie Mae and Freddie Mac. Therefore, on balance, I find these reports to be exceptionally useful for the current Hearings.

---

[1] The Fannie Mae (Federal National Mortgage Association -- FNMA) Report is: 1988-1989 Report to Congress on the Federal National Mortgage Association, Washington, D.C.: U.S. Department of Housing and Urban Development, June, 1990 (65 pages).

[2] The Freddie Mac (Federal Home Loan Mortgage Corporation -- FHLMC) Report is: 1989 Report to Congress on the Federal Home Loan Mortgage Corporation, Washington, D.C.: U.S. Department of Housing and Urban Development, June, 1990 (53 pages).

In order to improve future renditions of these reports, I recommend the inclusion of probabilistic analyses to assess the risks of financial difficulties at Fannie Mae and Freddie Mac. In the Reports, as they now stand, HUD develops "stress tests," which determine the longevity of Fannie Mae or Freddie Mac capital solvency during a "worst case" economic scenario, equivalent to the Great Depression. While this is an interesting data point for evaluating the riskiness of Fannie Mae and Freddie Mac, it does not provide a comprehensive picture of the risks involved with Governmental guarantees.

A probabilistic model, which includes estimates of the probabilities of various economic scenarios matched to the corresponding fiscal circumstances for Fannie Mae and Freddie Mac, could be used to calculate the expected cost of the guarantee system as well as a measure of the dispersion (e.g., the standard deviation) of costs over time. Such a model affords a more accurate long-run picture for policy evaluation by simultaneously presenting measures of how likely and how much the costs would be to Government.

OMB and Treasury Proposals for Regulatory Reform as Applied to Fannie Mae and Freddie Mac.

The OMB and the Treasury have submitted draft proposals for regulatory reform of Government-Sponsored Enterprises (GSE). The underlying common element in both draft proposals is the monitoring of the credit-worthiness of GSE's in order to determine whether they are fiscally sound. The Treasury would be the explicit guardian for safety and soundness regulation, and de facto apparently would coordinate and monitor the regulation of each GSE program. To measure the credit-worthiness of a GSE, each enterprise would be required to obtain a Triple-A (AAA) rating by the traditional capital market rating agencies. The "kicker" in the achievement of the AAA rating would be that it must necessarily be achieved without regard to any implicit or explicit Federal guarantee or other benefits.

The failure to meet the AAA credit-worthiness rating would require that the GSE create a business plan that would lead to an AAA rating. Presumably, the failure to meet the AAA rating would require restructuring to enhance the GSE's capital and/or reduce its leverage. The Treasury would be responsible for evaluating and improving such a business plan as well as monitoring its implementation.

If the plan were not approved, Treasury could at its discretion write an acceptable plan and direct the GSE to follow the Treasury mandate. As part of Treasury's regulatory control, it could change the fundamental business policies, including dividend, growth, debt issuance, and capital requirements. Finally, under the proposals, the Treasury would have far reaching powers which could extend to the revocation of the special status of the GSE obligations, and the replacement of the Board of Directors and/or principal officers of the GSE.

In essence, the OMB and Treasury proposals would permit the Treasury to be the principal "oversight" monitor of a GSE's credit-worthiness. The Treasury would have major powers to restructure and reorganize a GSE in order that it would become and maintain a standard of AAA credit-worthiness.

Analysis and Evaluation of the OMB-Treasury Proposals for GSE Regulatory Reforms as Applied to Fannie Mae and Freddie Mac.

In summary of my position, the OMB and Treasury proposals can not be evaluated because of insufficient evidence about their social impacts. However, it is clear that the adoption of these proposals is likely to have profound effects upon the mortgage markets; and is likely to change radically an efficiently operating part of the Capital Market. Without the calculation of the social benefits and social costs of these proposed changes in the regulation of Fannie Mae and Freddie Mac, one can not determine whether these proposals should be implemented. Governmental risks and costs are only one part of this type of calculation. I would recommend that these proposals be rejected (at least) until they are evaluated using an appropriately designed benefit-cost model.

At face value, any proposals that would rationalize the regulation and monitor the credit-worthiness of Fannie Mae and Freddie Mac should be welcomed, and are perhaps overdue. The notion that the Federal Government should have a method for controlling the riskiness of the business operations of Fannie Mae and Freddie Mac, particularly because of the implicit Government guarantees, seems well-founded. Unfortunately, upon closer scrutiny, the current OMB-Treasury proposals are unsettling, and probably rely upon premises that have no factual basis. A proper evaluation of the OMB-Treasury proposals, among other things, needs to take into account the following five elements:

1. The OMB-Treasury proposals appear to be overly concerned with potential Federal deficit implications without understanding the fundamental public sector roles for Fannie Mae and Freddie Mac: The Government policy and regulation of GSE's, such as Fannie Mae and Freddie Mac, must balance the overall social costs and the overall social benefits of policies, including redistributive effects. The Government _should be_ the ultimate insurer of financial catastrophe. If a major change in economic conditions regionally, nationally, and/or internationally should lead to massive financial problems in the mortgage markets, only the Government has the resources and capabilities of insuring these risks and correcting such a disaster scenario.

Also, historically the Government by serving as the _ultimate insurer_ (and, therefore, bearing ultimate capital risks) has promoted the integration of the mortgage market into the general capital market (by reducing information and transaction costs that would occur without these guarantees). In essence, the Government enhances the efficiency of the capital market, reducing the social costs of the capital and mortgage markets. Moreover, the benefit derived by enhancing the efficiency and magnitude of the mortgage market relates to improved housing quality and increased homeownership. The Treasury and the OMB proposals may have far reaching impacts on housing consumption, housing production, housing financing and mortgage markets. It appears that the proposals by OMB and the Treasury have not been subjected to a meaningful benefit-cost scrutiny. On this ground alone, I would return these proposals to the OMB-Treasury for further, more complete, and appropriate evaluation of the social benefits and costs.

2. As part of the OMB-Treasury proposals, Fannie Mae and Freddie Mac would have to attain AAA ratings for their financial paper without Government guarantees (implicit or explicit). It is unlikely that AAA ratings could be obtained without the implied Government guarantees. Imposing AAA rating requirements without taking into account Government guarantees is likely to lead to increased capital requirements for Fannie Mae and Freddie Mac and/or higher mortgage interest rates for consumers. Again, without measuring the costs and the benefits of these changes to society, including the impacts upon the functioning of the mortgage market, it is impossible to evaluate and appreciate what is the appropriate public sector position.

3. If, after systematic and proper evaluation of the costs and benefits of the implied guarantees and subsidies to Fannie Mae and Freddie Mac, the Government were bearing "too large" a risk, the increasing of capital requirements is not the only or perhaps not the preferred method for reducing the risks. While increasing the capital requirements, if they were found to be inadequate, would reduce Government risk by placing a more substantial capital shield by Fannie Mae or Freddie Mac against loss contingencies, the shield for the Government might be achieved through Government's sharing of annual income derived by Fannie Mae and Freddie Mac. The sharing formula simultaneously must be based upon the level of Government risk exposure and maintain profit incentives at Fannie Mae and Freddie Mac.

4. To the extent that Government policy insists (rightfully) on special programs in the mortgage market (e.g., low income or moderate income housing programs), and these programs cannot meet the standards established for credit-worthiness, these portions of the operations of Fannie Mae and Freddie Mac should be separated out from their other operations. They should not be included in the evaluation of the overall credit-worthiness of Fannie Mae and Freddie Mac; instead they should be looked upon as operations that serve a social function, and Government should subsidize and bear these risks.

5. It is clear that systematic quality-control and monitoring by the Government at the program management level should be instituted for Fannie Mae and Freddie Mac. This quality-control system should start with an analysis of the management system of Fannie Mae and Freddie Mac; and employ a management Information System (MIS) which could be used to develop quality-controls through auditing. One set of audits would be the normal periodic and systematic business operation audits. A second set of audits should provide early warning systems, which would indicate or predict that a particular program or operation within Fannie Mae or Freddie Mac is having problems, and can lead to rectification of these problems before they get "out of hand." Third, the use of MIS should also employ an in-depth random auditing of transactions and sub-organizational activities. This would be equivalent of the IRS random auditing to insure appropriate compliance with risk reductions and safeguards in operations.

Statement Prepared for Delivery by

ELDAD COPPENS

James D. Wolfensohn
Incorporated

Before the

SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS

of the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

August 2, 1990

My name is Eldad Coppens. I am pleased to be here today as a representative of JAMES D. WOLFENSOHN INCORPORATED, and welcome the opportunity to participate in this hearing. JAMES D. WOLFENSOHN INCORPORATED, located in New York, is an investment banking firm that specializes in providing strategic financial advisory services to a select group of clients representing a wide variety of industries ranging from financial services to manufacturing.

Our formal relationship with Fannie Mae began approximately a year ago when we were engaged to assist the Company in assessing the appropriateness of various measures of capital adequacy. My colleagues and I spent several months working together with the people at Fannie Mae in the process of developing various conclusions that were set forth in a letter to Fannie Mae's Chairman and CEO, Mr. David Maxwell, dated March 6. I would ask that this letter be included in the record of this testimony. Today I will focus on an important component of our analysis of Fannie Mae's capital adequacy -- the appropriateness of stress tests as a basis for measuring quantifiable risks and the use of such stress tests within a regulatory framework.

Relevance of Other Capital Guidelines

As a result of our consideration of currently employed standards of capital adequacy, we concluded that capital guidelines developed for other institutions in other industries, including those proposed or in effect for banks and thrifts, did not adequately account for the specific risks that Fannie Mae faces, and that, therefore, a more custom-tailored approach to assessing Fannie Mae's capital adequacy was justified.

Capital guidelines set for banks and thrifts by regulatory agencies by necessity are set for institutions engaging in a great variety of financial activities that do not readily lend themselves to the kind of quantitative analysis available to Fannie Mae. In contrast, Fannie Mae's business is focused solely on residential mortgages for lower- and middle level-priced houses and apartments. Sufficient data exist on the residential market for lower- and middle level-priced houses, and on the sensitivity of mortgage obligations to such features as loan-to-value ratios and other underwriting standards, to permit reasonable inferences to be drawn from historical experience about the risks of this business. With regard to the risk of mismatched asset and liability maturities, Fannie Mae has considerable ability to match-fund its mortgage assets through careful attention to its debt maturities, use of callable obligations and other hedging techniques. Many of these techniques are less readily available to banks and thrifts, and have not been uniformly adopted by those institutions.

Stress Tests: Measuring Quantifiable Risks

We found that "stress tests", which allow risks to be quantified based on an examination of the ability of a business to survive scenarios characterized by strongly adverse circumstances, provide the most promising foundation for understanding and controlling the specific risks faced by Fannie Mae.

Similar approaches, while differing in detail, are frequently used by other financial institutions and institutions that assess capital adequacy. We have concluded that, in the case of Fannie Mae, such stress tests are appropriate for assessing both the amount of capital required to withstand extreme credit and interest rate environments considered separately and the degree of overall stress that the Company could withstand without insolvency. In addition, the use of stress tests, by focusing on the principal risks faced by Fannie Mae, can provide useful guidance to management in its objective of controlling risk.

Credit and interest rate risks are the primary sources of risk to Fannie Mae. In its Mortgage-Backed Securities (MBS) operations, Fannie Mae incurs credit risk in both its non-recourse MBS (full Fannie Mae risk) and its recourse MBS (primary risk retained by mortgage originators). In its mortgage portfolio operations, Fannie Mae incurs both credit and interest rate risks. Because the credit risk for portfolio mortgages is substantially the same as that for non-recourse MBS, it is possible to measure Fannie Mae's credit risk across its two major lines of business, rather than for each separately.

Both credit risk and interest rate risks are suited to quantitative analysis based on historical experience. Other sources of risk, such as general business and management risk (e.g., fraud, systems failures, lack of adequate management controls, entering untested businesses, etc.), are inherently more difficult to quantify. However, conservative appraisal of the credit and interest rate risks, together with stress tests assuming an unlikely combination of the two, provide a margin of allowance against such ordinary business risk. Additional protection can be provided by surveillance of the Company by the appropriate supervisory authorities, as well as by an environment of strong management discipline.

Special Assumptions

Fannie Mae operates with certain constraints and advantages arising directly from its status as a Government-Sponsored Enterprise. For the purposes of our analysis, we assumed that these constraints and advantages would continue in future years. The constraints include both the narrow range of activities that Fannie Mae is permitted to undertake and the exercise of regulatory and supervisory authority by the Department of Housing and Urban Development (HUD). While in some instances these constraints may increase certain risks, government surveillance would appear to provide significant protection against the unknown risk of entry by the Company on a large scale into new and untested businesses and against imprudent management practices.

More important is the advantage derived from the widespread perception that, although the government is not legally liable for Fannie Mae's obligations, recourse to the

Treasury would be available if market stress were to limit Fannie Mae's access to the private credit markets. Federal government sponsorship encourages a lower cost of funds to Fannie Mae than would be available to a comparably organized and managed company without such federal government sponsorship. Similarly, the perception of implicit Treasury support provides Fannie Mae with substantial assurance of access to credit markets even under adverse circumstances that would limit or preclude access by similar issuers without such federal government sponsorship.

It is important to note that these assumptions lend validity and relevance to the stress test results in a regulatory framework inasmuch as they reduce market uncertainties and enhance the relevance of past experience in a limited range of activities.

Credit Risk

The stress test for credit risk subjects on- and off-balance sheet mortgages to nationwide rates of default and loan loss severity comparable to those experienced under strongly adverse circumstances in the past. In practice, there are a variety of ways to apply this concept. Fannie Mae's own stress test is based on the default rates and severity that Fannie Mae experienced (and expects to experience on a life-of-the-loan basis) on loans purchased by the Company that were originated in Texas in 1981 and 1982. These loans were acquired just prior to the onset of adverse economic developments in Texas that reduced employment and led to an oversupply of housing and a significant reduction in housing prices extending over several years.

According to Fannie Mae's own data, residential home mortgages originated in Texas in the early 1980's (specifically from 1981 to 1984) had the worst major regional default experience over any significant period since World War II. (Isolated incidents of higher default rates reflected localized and unusual problems, e.g., the experience of particular cities within Texas.)

Fannie Mae's credit risk stress tests relate Fannie Mae's loss experience on these Texas loans with key credit risk-related characteristics of loans currently held or guaranteed by the Company -- guaranty fee income, loan type, the original loan-to-value ratio, seasoning, and the existence of third party credit enhancements in the form of mortgage insurance, recourse to lenders or recourse backed by collateral. By making assumptions about these key characteristics, reflecting the composition of Fannie Mae's mortgage assets and obligations, it is possible to determine the amount of capital necessary to guard against specified credit contingencies.

Interest Rate Risk

The main risk facing Fannie Mae from shifts in interest rate stems from the possibility that the Company's assets and liabilities may be improperly matched. A substantial mismatch between asset and liability maturities was the primary cause of the substantial losses experienced by the Company in the first half of the 1980's.

In reviewing a number of interest rate scenarios and assessing the potential impact of interest rate changes on the profitability and capital position of Fannie Mae, we concluded that so called "mark-to-market" tests in themselves are inadequate for realistically assessing capital requirements with respect to interest rate risk. In particular, a simple comparison of the current market value of assets to the stated value of liabilities is plainly inadequate for institutions of Fannie Mae's character that can and do issue a variety of obligations, substantially matching assets and liabilities. Moreover, a more complex approach attempting to reflect mark-to-market or liquidation values of both the assets and liabilities of a financial institution often will not accurately reflect the firm's risk profile and current earnings capacity, and assigns no value to the future income-generating potential of a going concern.

We believe that single scenario tests based on adverse historical or hypothetical interest rate movements constitute a useful "common sense" complementary tool for assessing interest rate risk. Single scenario tests focus on the impact of interest rate changes on the net interest margin generated by a leveraged portfolio. Such tests also permit certain assumptions to be made about net portfolio growth, thus incorporating the net interest margin on new assets into the overall result for the portfolio.

The single scenario interest rate stress tests which we analyzed suggested that Fannie Mae would be able to maintain a positive net interest margin even if the country experienced a repetition of the 1978-1983 interest rate experience or an upward parallel shift in the yield curve of 600 basis points sustained for four years.

The Use of Stress Tests in a Regulatory Framework

In considering the use of stress tests in a regulatory framework, it is important to emphasize that stress tests provide a sound foundation for assessing the risks of institutions such as Fannie Mae whose businesses lend themselves to quantification. The ultimate decision regarding the degree of risk which it is proper for such institutions to bear, however, is a matter of public policy. While past experience is a useful guide to future uncertainties, no stress test can capture all of the possible contingencies. However, conservative appraisal of the credit and interest rate risks, together with stress tests assuming an unlikely combination of the two, provide a further margin of allowance.

The appropriate level of capital for any financial institution is, in the final analysis, a matter of judgment and not a mathematical or analytical certainty. A capital standard for Fannie Mae must balance the Company's business risks and objectives against the larger public purposes for which the institution was created, and must also give credit where due to management that has shown a steady track record of improved risk management. Finally, Fannie Mae's capital level should receive periodic reexamination by the Company's management and by the appropriate supervisory authorities, taking particular account of the balance struck between these factors.

JAMES D. WOLFENSOHN
INCORPORATED

599 LEXINGTON AVENUE
NEW YORK, NEW YORK 10022
PHONE (212) 909-8100
TELEX 661830

March 6, 1990

Mr. David O. Maxwell
Chairman of the Board and
Chief Executive Officer
Federal National Mortgage Association
3900 Wisconsin Avenue, NW
Washington, DC 20016-2899

Dear David:

In accordance with the agreement between the Federal National Mortgage Association ("Fannie Mae" or the "Company") and James D. Wolfensohn Incorporated, we have, over the past seven months, considered various approaches to assessing the capital adequacy of Fannie Mae and the adequacy of Fannie Mae's proposed standards ("Fannie Mae's proposed capital standards") to guard against capital insolvency and to minimize any risk to the taxpayer. We have not been requested to express our independent judgement as to what might be an appropriate capital standard for Fannie Mae or for a company engaged in a business comparable to Fannie Mae but without the explicit or implicit support of the federal government. We note, however, that the appropriate level of capital for any financial institution is, in the final analysis, a matter of judgement and not a mathematical or analytical certainty. A Government-Sponsored Enterprise such as Fannie Mae, in arriving at a capital standard, must balance its business risks and objectives against the larger public purposes for which the institution was created. Fannie Mae's capital level should in any event receive periodic reexamination by the Company's management and by the appropriate supervisory authorities, taking particular account of the balance struck between these factors.

Summary

The conclusions summarized below are based on an examination and analysis of information provided by Fannie Mae, which we have not independently verified, and of models developed by Fannie Mae to assess the impact of credit and interest rate stress on the Company's solvency. The analysis was based on a number of assumptions, identified below, that we believe to be reasonable. The conclusions must be interpreted in light of these assumptions and will be valid only to the extent the assumptions are borne out in practice.

The major conclusions from our work are as follows:

1. Simple applications of capital guidelines currently in effect or proposed for banks and thrifts in the U.S. and banks in leading countries throughout the world do not adequately reflect the particular characteristics of Fannie Mae. Those guidelines are necessarily designed for application to thousands of institutions involved in widely diversified commercial banking and related activities. In contrast, Fannie Mae is restricted by law from participating in the wider range of financial activities open to banks and thrifts. Its business is focused solely on residential mortgages for lower- and middle level-priced houses and apartments. The risks

associated with a large number of relatively standardized residential mortgages are more quantifiable, based on references to historical experience, than many banking risks. In addition, Fannie Mae has considerable ability to control interest rate risk by matching its assets and liabilities using funding techniques that are less readily available to banks and thrifts. Finally, Fannie Mae's sheer size and its unique position in the national economy provide additional justification for a custom-tailored approach to assessing the Company's capital adequacy.

2. The methods adopted by Fannie Mae for assessing capital adequacy, which include various stress tests and separate consideration of credit and interest rate risks, are appropriate as a basis for measuring the most important risks which the Company faces. Furthermore, such tests can help management to capitalize appropriately for the risks that the Company undertakes and to set goals for reducing those risks.

3. With respect to credit risk, Fannie Mae's proposed capital standards, as described below, would enable the Company to withstand a nationwide default rate for its mortgage assets equivalent to the estimated lifetime default rate experienced for loans purchased by Fannie Mae that were originated in Texas in 1981 and 1982. That regional experience, when projected nationwide, provides the basis for a standard allowing for nationwide losses significantly greater than those incurred on a nationwide basis for any prolonged period since World War II.

4. With respect to interest rate risk, given the Company's current balance sheet and net interest margin, Fannie Mae's current asset/liability matching position would permit the Company to maintain a positive net interest margin even if the country experienced a repetition of the 1978-1983 interest rate experience. That experience was characterized by the largest absolute changes in and highest levels of interest rates in the U.S. since World War II. Under the same assumptions, projections also indicate that the Company could maintain a positive net interest margin in a scenario in which there is an upward parallel shift in the yield curve of 600 basis points sustained for four years. Given these and other tests, Fannie Mae's proposed capital standard to guard against interest rate risk, which calls for a capital ratio of 50:1 on its portfolio assets, appears reasonable.

5. We have considered a variety of approaches to assessing Fannie Mae's capital adequacy with regard to interest rate risk that rely upon marking the Company's portfolio to market. We have concluded that so called "mark-to-market" tests in themselves are inadequate for realistically assessing capital requirements with respect to interest rate risk. In particular, a simple comparison of the current market value of assets to the stated value of liabilities is plainly inadequate for institutions of Fannie Mae's character that can and do issue a variety of obligations, substantially matching assets and liabilities. Moreover, a more complex approach attempting to reflect mark-to-market or liquidation values of both the assets and liabilities of a financial institution often will not accurately reflect the firm's risk profile and current earnings capacity, and assigns no value to the future income-generating potential of a going concern.

6. Taking account of the factors above and in the light of Fannie Mae's business judgement and the public purposes served, Fannie Mae's management plans to attain and maintain the following capital ratios: non-recourse credit risk at a ratio of 135:1, recourse and collateralized credit risk at 250:1, the interest rate risk on its on-balance sheet mortgages at 50:1, and the

credit and interest rate risk of its other on-balance sheet assets at 50:1. Given the assumptions below, maintenance of these ratios, once obtained, would provide the Company with a margin of capital to withstand difficulties in the housing markets and movements in interest rates of a character significantly worse than any experienced over the nation as a whole in the post-World War II period. Given such a capital position, and assuming that Fannie Mae maintains subordinated debt in relative amounts comparable to the $2.3 billion currently outstanding, we believe that the risk of loss to the taxpayer due to the insolvency of Fannie Mae would be remote.

7. Fannie Mae has made projections of the growth of its assets and obligations assuming the continuation of its current underwriting standards, no material increase in the average loan-to-value ratios of its mortgages, and continued adherence to its present asset/liability matching policies. Without independently assessing the reasonableness of Fannie Mae's projections, we have applied Fannie Mae's proposed capital standards to the Company's projected balance sheet. Given those assumptions, the capital required by Fannie Mae at the end of 1991 would rise to close to $6.0 billion. Fannie Mae has expressed its strong conviction that through a combination of retained earnings and growth in its loan loss reserves, the Company will achieve this level of capital by the end of 1991. This does not include the potential addition to capital of approximately $500 million arising from the possible exercise of equity warrants expiring in February 1991. Conditions could arise, of course, that would make it difficult or impossible for Fannie Mae to meet its projections.

GENERAL DISCUSSION

Examination of Data

In conducting our investigation, we have familiarized ourselves to the extent that we deemed appropriate and feasible with Fannie Mae's business operations and financial condition, relying upon publicly available information and other information that was supplied by Fannie Mae. We have not independently verified this information. While we have sought to familiarize ourselves with the data received from Fannie Mae and with the overall structure and implicit logic of the various computer simulation models used by Fannie Mae in connection with this investigation, we cannot guarantee the soundness or authenticity of such data and/or models.

Definition of Capital

For the purposes of the following analysis and discussion, capital is defined as the sum of equity and general loss reserves. Currently, Fannie Mae's total capital, thus defined, amounts to about $3.5 billion.

Fannie Mae's $2.3 billion in subordinated debt, which qualifies as capital under Fannie Mae's Charter Act, and which is analogous to tier II capital in the bank capital guidelines, is excluded from this definition of capital. The offering circulars for Fannie Mae's subordinated debt explicitly state that it is subordinated to Fannie Mae's currently outstanding and future senior debt issued under section 304 (b) of the Charter Act. This would include any claim of the Treasury, including a claim in liquidation, arising from any future Treasury purchase of the Company's senior debt obligations as provided in the Charter Act. The terms of Fannie Mae's subordinated debt explicitly provide that holders of the Company's subordinated debt will receive no payment of principal or interest as long as there is an outstanding event of default (including failure to pay interest or principal) on any senior debt, including any debt issued to the Treasury.

Relevance of Other Capital Guidelines

As a result of our consideration of currently employed standards, we have concluded that capital guidelines developed for other institutions in other industries, including those proposed or in effect for banks and thrifts, do not adequately take account of the specific risks that Fannie Mae faces. Therefore, a more custom-tailored approach to assessing Fannie Mae's capital adequacy is justified.

Capital guidelines set for banks and thrifts by regulatory agencies by necessity are set for institutions engaging in a great variety of financial activities that do not readily lend themselves to the kind of quantitative analysis available to Fannie Mae. In contrast, Fannie Mae's business is focused solely on residential mortgages for lower- and middle level-priced houses and apartments. Sufficient data exist on the residential market for lower- and middle level-priced houses, and on the sensitivity of mortgage obligations to such features as loan-to-value ratios and other underwriting standards, to permit reasonable inferences about the risks of this business to be drawn from historical experience. With regard to the risk of mismatched asset and liability maturities, Fannie Mae has considerable ability to match-fund its mortgage assets through careful attention to its debt maturities, use of callable obligations and other hedging techniques. Many of these techniques are less readily available to banks and thrifts, and have not been uniformly adopted by those institutions.

Fannie Mae's Determination of Capital Adequacy

Fannie Mae is justified in adopting the approach of separately considering various sources of risk as a basis for measuring the aggregate risk faced by the business in the normal course of operations. Credit risk and interest rate risk constitute the predominant sources of Fannie Mae's risks, and both are suited to a quantitative analysis based on historical experience. Other sources of risk, such as general business and management risk (e.g., fraud, systems failures, lack of adequate management controls, entering untested businesses, etc.), are inherently more difficult to quantify. However, conservative appraisal of the credit and interest rate risks, together with stress tests assuming an unlikely combination of the two, provide a margin of allowance against such ordinary business risk. Additional protection can be provided by surveillance of the Company by the appropriate supervisory authorities in the context of limitations set forth in the Charter, as well as by an environment of strong management discipline.

An approach to quantifying risk based on an examination of the ability of a business to survive scenarios characterized by strongly adverse circumstances is broadly suitable to both mortgage credit and interest rate risks. Similar approaches, while differing in detail, are frequently used by other financial institutions and institutions that assess capital adequacy. Thus, the use of such stress tests would appear to be appropriate for assessing both the amount of capital required by Fannie Mae to withstand extreme credit and interest rate environments considered separately and the degree of overall stress that the Company could withstand without insolvency. In addition, the use of stress tests, by focusing more clearly on the principal risks faced by Fannie Mae, can provide useful guidance to management in its objective of controlling risk.

A proper assessment of Fannie Mae's capital adequacy must take account of any significant changes in the Company's financial condition or operating policies. In recent years Fannie Mae has achieved a substantial strengthening of its financial position, has adopted more conservative underwriting standards, and has significantly reduced its exposure to interest rate risk. Partly as a result of relatively stable interest rates in recent years and the overall prosperous economic environment, the Company has been able to increase its profitability significantly. This, together with the Company's low dividend payout ratio, has resulted in substantial additions to capital through retained earnings. Reflecting investors' perceptions of the Company's improved financial position, the interest rate spread between Fannie Mae and Treasury debt has fallen to low levels, after increasing substantially during the adverse conditions of the early 1980's.

Given Fannie Mae's history and charter, the Company operates with certain constraints and advantages arising directly from its status as a Government-Sponsored Enterprise. For the purposes of this analysis, we have assumed that these constraints and advantages will continue in future years. The constraints include both the narrow range of activities that Fannie Mae is permitted to undertake and the exercise of regulatory and supervisory authority by the Department of Housing and Urban Development (HUD). While in some instances these constraints may increase certain risks, government surveillance would appear to provide significant protection against the unknown risk of entry by the Company on a large scale into new and untested businesses and against imprudent management practices.

More important is the advantage derived from the widespread perception that, although the government is not legally liable for Fannie Mae's obligations, recourse to the Treasury would in fact be available if market stress were to limit Fannie Mae's access to the private credit markets. Federal government sponsorship encourages a lower cost of funds to Fannie Mae than would be available to a comparably organized and managed company without such federal government sponsorship. Similarly, the perception of implicit Treasury support provides Fannie Mae with substantial assurance of access to credit markets even under adverse circumstances that would limit or preclude access by similar issuers without such federal government sponsorship.

Analysis of Fannie Mae's Risks

As previously mentioned, credit and interest rate risks are the primary sources of risk to Fannie Mae. In its Mortgage-Backed Securities (MBS) operations, Fannie Mae incurs credit risk in both its non-recourse MBS (full Fannie Mae risk) and its recourse MBS (primary risk retained by mortgage originators). In its mortgage portfolio operations, Fannie Mae incurs both credit and interest rate risks. Because the credit risk for portfolio mortgages is substantially the same as that for non-recourse MBS, it is possible to measure Fannie Mae's credit risk across its two major lines of business, rather than for each separately.

Credit Risk

Fannie Mae has developed a methodology that subjects on- and off-balance sheet mortgages to stress tests that assume nationwide rates of default comparable to those experienced by the Company in recent years in adverse housing market conditions in specified regions. In particular, Fannie Mae's proposed capital standards for credit risk are based on the default rates that Fannie Mae experienced (and expects to experience on a life-of-the-loan basis) on loans purchased by the Company that were originated in Texas in 1981 and 1982. These loans were acquired just prior to the onset of adverse economic developments in Texas that reduced employment and led to an oversupply of housing and a significant reduction in housing prices extending over several years.

According to Fannie Mae's own data, residential home mortgages originated in Texas in the early 1980's (specifically from 1981 to 1984) had the worst major regional default experience over any significant period since World War II. (Isolated incidents of higher default rates reflected localized and unusual problems, e.g., the experience of particular cities within Texas.)

Fannie Mae's credit risk stress tests relate Fannie Mae's loss experience for these Texas loans with key credit risk-related characteristics of loans currently held or guaranteed by the Company -- guaranty fee income, loan type, the original loan-to-value ratio, seasoning, and the existence of third party credit enhancements in the form of mortgage insurance, recourse to lenders or recourse backed by collateral. By making assumptions about these key characteristics in the future, it is possible to determine the amount of capital necessary to guard against specified credit contingencies across the range of the Company's credit risk assets and obligations. In addition to default rates and loss severities reflective of the Texas experience, Fannie Mae's credit risk stress test captures the adverse effects of prepayments and a decline in float income that would be likely to occur in an environment of declining interest rates. The analysis also assumes that losses related to credit risk can be applied by the Company for tax purposes to offset profits from the portfolio's net interest margin, or for tax loss carrybacks to the extent permissible under the current U.S. tax code.

While we have not audited the mathematical equations of the model used to generate the results for the credit risk stress test, the results appear to be reasonable based upon an examination of the key variables and assumptions of the model. These variables, and the respective assumptions made, include, but are not limited to:

1) Guaranty fee income (maintenance of current 23.5 basis points on non-recourse MBS and 18 basis points on recourse MBS): The guaranty fee provides a stream of future earnings available at least in part to cover future losses, reducing the level of initial capital that would otherwise be required.

2) Original loan-to-value (LTV) ratio (maintenance of current weighted average of approximately 75% LTV, using the appraised value at the time of mortgage origination): Loans with a lower LTV generally have a lower default rate. Fannie Mae has in recent years substantially reduced the weighted average LTV ratio of its risk assets.

3) Loss severity (assumed to average approximately 25% of the unpaid principal balance for foreclosed mortgages): The level of loss severity, i.e. the ultimate loss absorbed after foreclosure of a mortgage, is based on Fannie Mae's historical loss experience from loans originated in Texas in the early 1980's. It reflects carrying costs, foreclosure and disposition costs, and the difference between the sale price and the mortgage amount.

4) A variety of mortgage assets: Currently, Fannie Mae's portfolio of mortgages and non-recourse MBS is heavily weighted to traditional 30-year amortizing fixed-rate mortgages. The rest consist of intermediate term amortizing mortgages, adjustable-rate mortgages (ARMs), and other types of mortgages. Each of these categories faces different levels of credit risk. For example, intermediate term mortgages are assumed to have a lower level of credit risk than 30-year fixed-rate mortgages. Conversely, adjustable-rate mortgages are assumed to have a higher level of credit risk relative to 30-year fixed-rate mortgages, although this judgement is based on a limited experience with such assets.

5) Broad geographical diversification: By maintaining a broad national distribution of mortgages, Fannie Mae can diversify its credit risk and mitigate the effects of regional economic downturns. Fannie Mae is well diversified geographically.

6) Maintenance of strict underwriting standards: By controlling underwriting standards, Fannie Mae can significantly control its credit risk exposure. We note that Fannie Mae has stricter underwriting standards than those in use before 1986, and that it intends to maintain these standards. The stricter underwriting standards include, but are not limited to, underwriting high LTV ratio ARMs at the estimated second-year payment rate, eliminating high-risk loan types such as graduated payment ARMs, and reducing payment-to-income ratios for 95% LTV mortgages.

7) Recourse and collateral: Financial institutions selected for recourse MBS are carefully reviewed and monitored for soundness, and the collateral, when required, for recourse MBS is sound and held separately and specifically for Fannie Mae's benefit.

8) Mortgage insurance: Fannie Mae requires all mortgages with an LTV higher than 80%, other than those with other forms of credit enhancement, to be covered by mortgage insurance for the amount above 75% LTV.

9) Various levels of seasoning: The amount of credit risk capital provided for seasoned mortgages may be less than that for unseasoned mortgages to the extent that seasoned mortgages are less likely to default. Based on current and historical data, the adjustment that Fannie Mae makes for seasoning seems reasonable. This adjustment should be periodically reviewed by Fannie Mae and its regulatory authorities, particularly if housing prices display a level or declining trend.

Fannie Mae has chosen to calculate its credit risk capital requirements primarily on the basis of its experience with mortgages originated in Texas in 1981 and 1982, for which the lifetime estimated default rate is approximately the average of that for Texas loans originated between 1981 and 1984. The lifetime default rate projected for Fannie Mae's 30-year fixed-rate mortgages originated in 1981 and 1982 in Texas, when reweighted to reflect the LTV ratios of the Company's current mortgages, is 9.0%. The worst comparable nationwide estimated lifetime default rate experienced by Fannie Mae since World War II for loans originated in any four year period, calculated in a similar manner, is 5.7% (1981-1984). For any two years it is 7.0% (1981-1982), and for any single year it is 7.3% (1982). We note that because Fannie Mae's assets and obligations were purchased over a number of years, multi-year averages are relevant. On the basis of a comparison of such data, we have concluded that a national experience on the scale specified would be significantly worse than any encountered at any time in the post-World War II era, including the recessions of the mid-1970's and early 1980's.

Because the experience of the 1930's is widely referenced as a benchmark experience upon which to base extreme credit risk stress tests, we have also examined more limited and fragmentary Great Depression default data. Although there is substantial evidence that the overall default rate and decline in housing prices actually experienced during the Great Depression were substantially worse than for any sizeable region or extended time period since World War II, it is difficult to draw reliable conclusions from stress tests based on available data from the 1930's experience. In particular, we note that the sample size for fixed-rate fully amortizing mortgages of the type prevalent today originated in the 1930's is very small and that mortgage origination practices that were commonly in use in that era are not entirely comparable to those of today.

Given the characteristics of Fannie Mae's current book of business, Fannie Mae's analysis indicates that a capital ratio of approximately 135:1 for Fannie Mae's non-recourse credit risk would meet Fannie Mae's capital standard. For recourse credit risk, where Fannie Mae is protected either by a guarantee of well established financial institutions acting as mortgage originators or by such a guarantee in combination with collateral equivalent to approximately 10% of an MBS issue, Fannie Mae proposes a capitalization ratio of 250:1

Interest Rate Risk

The main risk facing Fannie Mae from shifts in interest rates stems from the possibility that the Company's assets and liabilities may be improperly matched. A substantial mismatch between asset and liability maturities was the primary cause of the substantial losses experienced by the Company in the first half of the 1980's.

Since that time, Fannie Mae has made considerable progress in closing the mismatch. Moreover, as a result of the Company's ability to fund mortgage assets with a variety of maturities of debt, including callable debt and other innovative financial instruments, Fannie Mae should be well positioned in the future to manage its liabilities in a manner that further reduces interest rate risk. We recommend that the Company implement its plans with respect to such funding structures as opportunities permit, and it is our understanding that the Company fully intends to do so. While we believe that Fannie Mae possesses state-of-the-art techniques, including sophisticated financial tools and computer modeling, which assist the Company in achieving a closer match of its assets and liabilities, we also note that perfect hedges against all possible interest rate scenarios are not possible, given the options available to the mortgagor for refinancing in response to market fluctuations.

In reviewing a number of interest rate scenarios and assessing the potential impact of interest rate changes on the profitability and capital position of Fannie Mae, we have concluded that so called "mark-to-market" tests in themselves are inadequate for realistically assessing capital requirements with respect to interest rate risk. In particular, a simple comparison of the current market value of assets to the stated value of liabilities is plainly inadequate for institutions of Fannie Mae's character that can and do issue a variety of obligations, substantially matching assets and liabilities. Moreover, a more complex approach attempting to reflect mark-to-market or liquidation values of both the assets and liabilities of a financial institution often will not accurately reflect the firm's risk profile and current earnings capacity, and assigns no value to the future income-generating potential of a going concern.

We have reviewed the results of both stochastic and single-scenario tests in assessing the interest rate sensitivity of Fannie Mae's portfolio business, analyzing the effects of interest rate movements on both profit and retained capital. Fannie Mae's stochastic model incorporates a modified form of marking assets and liabilities to market in a computer simulation using a random walk assumption to project into the future a wide variety of possible interest rate changes, assigning probabilities to each on the basis of past experience. Such simulations are an increasingly important tool for financial management, and we encourage Fannie Mae's continued development and use of such advanced techniques. However, in reaching our conclusions, we have not relied entirely on this model because the results which it generates are difficult to interpret and may not accurately capture the range of uncertainties involved in judging interest rate sensitivity.

Given these limitations in the application of stochastic tests, we believe that single scenario tests based on adverse historical or hypothetical interest rate movements continue to constitute a useful "common sense" complementary tool for assessing interest rate risk. In contrast to the stochastic simulations, the single scenario tests of the kind that we have reviewed focus on the impact of interest rate changes on the net interest margin generated by a leveraged portfolio. Such tests also permit certain assumptions to be made about net portfolio growth, thus incorporating the net interest margin on new assets into the overall result for the portfolio.

Fannie Mae has conducted two single scenario tests using its business planning model. In each of the tests, it was conservatively assumed that the size of the portfolio would be held constant, with projected mortgage liquidations assumed to be replaced by a similar volume and mix of new purchases. Maturing debt was assumed to be reissued at maturities that kept the average life of outstanding debt unchanged.

The first test simulated the 1978 to 1983 interest rate experience, which was characterized by the largest absolute changes in and the highest levels of interest rates in the U.S. since World War II. The test indicates that given its current balance sheet, net interest margin, and asset/liability structure, Fannie Mae would continue to maintain a positive net interest margin during such a period, in sharp contrast to its actual experience between 1978 and 1983.

The second simulation assumed a parallel upward shift in the yield curve of 600 basis points over a twelve month period starting from the November 1989 level. Interest rates were assumed to remain at this higher level for four years. As a result of the positive interest margin on its retained earnings, Fannie Mae could maintain a positive net interest margin throughout this scenario as well.

These single scenario tests, interpreted on the basis of the Company's current asset/liability mix and net interest margin, suggest a low probability of strain on capital from interest rate changes in the immediate future. Looking toward the indefinite future, Fannie Mae has proposed a capital ratio for interest rate risk of 50:1 for its on-balance sheet mortgage portfolio assets. In our judgement, on the basis of our examination of the results of both stochastic models and single scenario tests, that standard appears reasonable, assuming the maintenance of the Company's current net interest margin and continuation of the present or improved asset/liability matching policies. We note that such a standard would be adequate to protect against interest rate movements significantly more adverse than any experienced in the U.S. since World War II.

Other Assets and "Business Risk"

Fannie Mae plans to maintain a capitalization ratio for non-mortgage assets of at least 50:1. While necessarily somewhat arbitrary, such an allowance appears generally reasonable given that these other assets are predominately high-grade liquid securities and are assumed to remain so.

No explicit allowance is made for other extraordinary business risks ranging from fraud to mismanagement. We believe, however, that in a closely supervised institution confined to basically one line of business in which it is expert, such risks are likely to be small relative to the credit and interest rate risks which have been explicitly incorporated into the analysis. Moreover, it is unlikely that all of the adverse circumstances with respect to credit and interest rate risks will materialize simultaneously, implicitly providing a further margin of protection against these other risks.

Conclusion

The specific capitalization ratios and policies cited above are based on Fannie Mae's existing policies and operations, and can be expected to change with significant changes in the key variables discussed above. Furthermore, we note that the appropriate level of capital for any financial institution is, in the final analysis, a matter of judgement and not a mathematical or analytical certainty. A Government-Sponsored Enterprise such as Fannie Mae, in arriving at a capital standard, must balance its business risks and objectives against the larger public purposes for which the institution was created. Fannie Mae's capital level should in any event receive periodic reexamination by the Company's management and by the appropriate supervisory authorities, taking particular account of the balance struck between these factors.

Fannie Mae has stated that it is reasonable to anticipate that during 1990 and 1991 the Company will experience growth of approximately $100 billion in the assets and obligations on which it bears non-recourse credit risk, growth of close to $20 billion each in its recourse credit risk obligations and in the on-balance sheet mortgages on which the Company is exposed to interest rate risk, and little or no growth in its non-mortgage assets.

Under Fannie Mae's proposed capital ratios and assuming continuation of Fannie Mae's current underwriting standards, no material increase in the average loan-to-value ratios of its mortgages, continued adherence to or strengthening of its policies of duration matching, and maintenance of the Company's net interest margin and guaranty fees, such increases in Fannie Mae assets and obligations would result in a capital requirement at the end of 1991 of approximately $6.0 billion. Fannie Mae has expressed its strong conviction that through a combination of retained earnings and growth in its loan loss reserves, the Company will achieve this level of capital by that time. This does not include the potential addition to capital of approximately $500 million arising from the possible exercise of equity warrants expiring in February 1991. In support of its conviction, Fannie Mae notes that its retained earnings and loan loss reserves increased by $500 million in 1988, and by an additional $797 million in 1989.

In our judgement, should Fannie Mae achieve a capital position within the framework and standards described above, the Company would be in a position to maintain its solvency in the face of difficulties in the housing markets and an interest rate environment significantly more adverse than any experienced in the post-World War II period. In reaching that judgement, we have assumed the continuation of Fannie Mae's status as a Government-Sponsored Enterprise, with the implication that access to credit would be maintained even under such circumstances. Given such a capital position, and assuming that Fannie Mae maintains subordinated debt in relative amounts comparable to the $2.3 billion currently outstanding, we believe that the risk of loss to the taxpayer due to the insolvency of Fannie Mae would be remote.

Very truly yours,

JAMES D. WOLFENSOHN INCORPORATED

Paul A Volcker

By Paul A. Volcker

Hope from Homes

THE ENTERPRISE FOUNDATION

JAMES W. ROUSE
CHAIRMAN

F. BARTON HARVEY, III
DEPUTY CHAIRMAN

EDWARD L. QUINN
DEPUTY CHAIRMAN

PAUL C. BROPHY
PRESIDENT

WALTER G. FARR
VICE PRESIDENT

PATRICIA T. ROUSE
SECRETARY - TREASURER

TRUSTEES

HARRY W. ALBRIGHT, JR.
JOHN P. BOORN
PAUL C. BROPHY
LISLE C. CARTER, JR.
RAYMOND G. CHAMBERS
N. GORDON COSBY
MATHIAS J. DeVITO
CUSHING N. DOLBEARE
JOHN W. GARDNER
SAMUEL GARY
W. H. KROME GEORGE
RONALD GRZYWINSKI
F. BARTON HARVEY, III
ANDREW HEISKELL
JING LYMAN
LOUIS E. MARTIN
CHARLES McC. MATHIAS, JR.
DAVID O. MAXWELL
ROBERT S. McNAMARA
MILTON J. PETRIE
EDWARD L. QUINN
HENRY S. REUSS
JAMES W. ROUSE
PATRICIA T. ROUSE
ANDREW C. SIGLER
STEPHEN STAMAS
ELLEN SULZBERGER STRAUS
MICHAEL H. WALSH
ANDREW J. YOUNG
RAUL YZAGUIRRE
BARRY ZIGAS

HONORARY TRUSTEES

COY EKLUND
ERNEST W. HAHN
LEEDA MARTING
RICHARD D. PARSONS
CHARLES S. ROBB
ALEXANDER B. TROWBRIDGE

Statement of
The Enterprise Foundation
Before
The Senate Subcommittee on Housing and Urban Affairs
on
The Safety and Soundness of
Fannie Mae and Freddie Mac

Thursday, August 2, 1990

Mr. Chairman and members of the Subcommittee, it is a pleasure to have this opportunity to appear before you on behalf of The Enterprise Foundation. I am Bart Harvey, Deputy Chairman of The Enterprise Foundation, a publicly supported nonprofit organization which operates in over 40 cities, with over 100 nonprofit groups, helping to provide decent, affordable housing to poverty level individuals and families across the country.

The Enterprise Foundation has worked extensively with Fannie Mae and Freddie Mac in the course of its operations. The Foundation assists grassroots nonprofit groups with their programs to rebuild housing and community in some of the most distressed neighborhoods in the country. Enterprise assists these groups with "seed" capital, assistance in the lowest cost means of rehabilitating buildings through its Rehab Work Group, special financing, and financial packaging assistance through its Enterprise Social Investment Corporation (ESIC).

To date, Enterprise has put over $200 million back into nonprofit sponsored housing through grants, loans, equity investments and technical assistance. This "seed" capital is leveraged many times over with private sector, state, local, and federal financing.

Most of our contact with Fannie Mae and Freddie Mac has involved their participation in specially tailored financing programs to reach very low income individuals and families. We are, however, also aware of these government sponsored enterprises' importance in the conventional financing for millions of low- and moderate-income families in this country.

500 AMERICAN CITY BUILDING, COLUMBIA, MARYLAND 21044 • 301 / 964-1230

Treasury and O.M.B. Proposals

I would like to comment on proposed changes to the way and rules under which Fannie Mae and Freddie Mac would be regulated as proposed by Treasury and O.M.B. Certain aspects of these proposals, in our view, would dramatically change the way these government sponsored enterprises deal with providing decent housing for low- and moderate-income families. In our view, one of the two purposes H.U.D. cited in its 1988-1989 Report to Congress as reasons for its regulation, might be compromised:

"to ensure that the activities of FNMA [and Freddie Mac] serve the public purposes for which it was created." (Page 47)

Historical Context-Public Purpose of Fannie Mae and Freddie Mac

Since their creation by Congress in 1938 and 1970, Fannie Mae and Freddie Mac, respectively, played an integral role in federal housing policy by creating an efficient, deep, national secondary mortgage market. As restated in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Fannie Mae and Freddie Mac were accorded similar charters and purposes to: (1) provide stability in the secondary market for home mortgages; (2) respond appropriately to the private capital market; and (3) provide ongoing assistance to the secondary market for home mortgages (including low- and moderate- income family mortgages involving a reasonable economic return) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for home mortgage financing.

By virtue of its federal charter and purpose, Fannie Mae and Freddie Mac have access to a number of benefits from the federal government which accord it "agency status" or gives them an "implied guarantee" of the federal government. Thus, the need for the second purpose of H.U.D.'s regulatory oversight:

"to ensure that the activities of Fannie Mae [and Freddie Mac] do not create unreasonable risks for the federal government." (Page 47)

How well have these agencies succeeded in their public purpose? Do they, as currently capitalized and run, create unreasonable risks for the federal government?

By Treasury's, O.M.B.'s and H.U.D.'s own analysis, and by observable fact, these companies have succeeded magnificently, expanding the base of investors in mortgages (even internationally) and reducing costs to the homebuyers. They have brought stability and standardization to the mortgage market and been creative and experimentally successful in offering new mortgage products. It is estimated that they have reduced mortgage costs to homebuyers by as much as three-quarters of a point, essentially making housing affordable to more Americans.

Furthermore, they have provided a national mortgage market in good times and bad, and been a stabilizing factor during times of interest rate instability and real estate uncertainty. They have maintained operations in parts of the country beset by regional economic crisis (such as the Southwest in the 1980's) and provided an ongoing market when banks and thrifts would not make loans that could not be securitized. Clearly, their single purpose mandate -- to provide and facilitate residential finance -- makes these companies an important factor in national housing policy.

Moreover, Fannie and Freddie have well-served their Congressional intent to assist the secondary mortgage markets for low- and moderate-income families involving a reasonable return. Citing Fannie Mae's statistics, in 1989, the average loan purchased or securitized was $83,000 with nearly 20 percent of such loans under $40,000. Similarly, one-third of all 1- to 4-family mortgages purchased by Freddie Mac were below $60,000. Clearly, in its conventional single family mortgage activities, both agencies are reaching moderate- and low-income families.

Particularly important to the Enterprise Foundation in dealing with low-income families, are both the interest rate of the mortgage and the amount of the down payment and closing costs. Any changes in regulation of Fannie and Freddie which would cause lenders to increase mortgage rates or increase required down payment amounts would seriously jeopardize the ability of lower income families to afford a house. The effects of the Treasury/O.M.B. proposals, should they cause interest rates to rise or down payment amounts to increase, would disproportionately effect poor people.

Nonconventional Low- and Moderate-Income Housing Activity

Coupled with Fannie's and Freddie's servicing of low- and moderate-income individuals through the conventional market, are the specialized activities of both agencies to meet the needs of low-income families which do not qualify for conventional financing.

Since 1987, Fannie Mae alone has committed to invest approximately $4.0 billion, assisting over 80,000 low- and moderate-income families, through a variety of programs. Enterprise and other national nonprofit organizations have worked with Fannie Mae to overcome down payment, credit history and neighborhood difficulties to provide mortgages under a number of single family community lending activities.

Freddie Mac has also been active in developing single-family affordable housing programs aimed at lower-income individuals. Recently, Freddie Mac created a new Affordable Housing Initiatives Department that will coordinate the Corporation's low-income housing activities. Freddie Mac announced earlier this month a $500 million public-private partnership with the state of Michigan that will provide more than 10,000 families with access to mortgage financing by modifying underwriting and servicing guidelines, providing homebuyer education and counseling, sharing of credit risk, and involving community groups. Freddie Mac hopes that this program will serve as a prototype for similar programs in other states.

Both Fannie and Freddie have been important forces in multifamily community lending activities and in investing in tax credit multifamily projects providing decent, affordable housing for homeless, and very low-income individuals and families.

Both agencies have been responsive to finding ways to meet the needs of hundreds of thousands of families otherwise precluded from the housing market or from affordable rents.

Role in Current Housing Environment

In reviewing the public purpose activities of these two government sponsored enterprises, it is important to note the environment in which these companies are operating:

* the federal government has severely cut its assistance to low- and moderate-income housing over the past decade.

* the thrift industry, traditional mortgage financiers of low- and moderate-income families, has been in severe decline over the past decade.

* new federal agencies, such as the R.T.C., are relying on Fannie and Freddie to assist in financing its sale of the affordable housing stock in its inventory.

* new Community Reinvestment Act ("CRA") requirements will encourage lenders to work more closely with Fannie and Freddie to fashion sound programs to reach low- and moderate- income families.

In each case, the public purpose utility of Fannie and Freddie is apparent and essential to low- and moderate- income families. Yet it is possible only if they maintain the lowest possible mortgage interest rates and have the financial leeway to respond responsibly and creatively to reach low- and moderate-income family housing needs.

Impact of Treasury/O.M.B. Proposals on Low-Income Families

In reviewing the possible impact of the Treasury/O.M.B. proposals, it is ironic to note that although Fannie and Freddie have an "implied guarantee" from the federal government, they have never had to call on their line of credit from the government. Three federal agencies - Treasury, the G.A.O. and H.U.D.- have all looked at these questions of capital adequacy and declared Fannie and Freddie sound. Yet, it is another's, the thrift industry's, crisis that imposes new proposals for regulation on healthy government sponsored enterprises which have carried out their public purpose superbly.

Our belief is that if the Treasury/O.M.B. proposals are enacted, Fannie and Freddie will react rationally and to the disadvantage of low- and moderate- income families which will suffer disproportionately. Without being experts, it might be expected that requiring these companies to build capital to meet a triple-A rating would have an adverse impact on the cost and availability of mortgage credit. Furthermore, OMB-proposed penalties or Treasury sanctions for not meeting triple-A status would cause Fannie and Freddie to be adverse to any program with credit risk, or even the rating agencies' negative perception of a program's credit risk. All too often, programs which serve lower income families are prone to such negative perception.

If these proposals are enacted, from Enterprise's point of view, the public purpose reason for Fannie and Freddie will be sacrificed to capital surety, essentially removing the reason for the government's "implied guarantee". If it is assumed that H.U.D. and Fannie and Freddie have worked out a capital structure program that leaves these companies sound under all but the most extreme economic scenarios, then it is their special relationship with the government that allows them to carry out their public purpose -- important interest rate savings; a stable, liquid, national mortgage market; continuous and ongoing activities in the mortgage markets regardless of regional economic disparities; and special attention to low- and moderate-income mortgages.

Allowing a private rating agency to dictate a conservative mortgage credit policy may eliminate some risk to the federal government but also eliminates much of the public policy capacity for Fannie and Freddie to serve low-income Americans. It seems like another assault on affordable housing policy in this country.

If these proposals are enacted, it is likely that:

(1) mortgage interest rates would rise marginally but importantly for lower income families;

(2) low down payment loans would come under increasing pressure requiring more risk adjusted capital;

(3) mortgages in depressed regions would be more difficult to make and sell;

(4) nonconventional lending to lower income families would decrease as Fannie and Freddie reacted to private rating agencies' perceptions of risk; and

(5) Fannie and Freddie's willingness and ability to help serve a national housing policy agenda would decrease due to the strictures of holding its triple-A rating. Working with the RTC, or lenders on specialized CRA activities would become less attractive.

H.U.D. Actions to Date

From our vantage point, H.U.D. has clearly and responsibly set out its twin purposes in its Report to Congress -- for Fannie and Freddie to serve their public policy purpose and to not create "unreasonable risks" to the federal government. We believe that the Treasury/O.M.B. proposals sacrifice good public policy to mitigate a small risk to the federal government.

We believe H.U.D.'s stress test methodology to quantify the level of risk at given capital levels is an important tool which can be utilized in cooperation with Fannie and Freddie to devise an appropriate long-term business and capital retention plan. Surely, with these two companies which are currently financially sound and operating well, it makes no sense to suddenly change the nature of their operations and their regulation -- particularly without adequate consideration of the public policy consequences.

The delicate balance between financial soundness and public policy properly resides in H.U.D. and with its oversight.

Additional Suggestions

H.U.D. has enumerated the steps it is taking internally to ensure its own expertise in analyzing and evaluating the credit risk of Fannie and Freddie. Most of the steps it is taking to improve its regulation involve risk analysis but does not concern public policy analysis.

Specifically, Fannie and Freddie should be encouraged to devise programs meeting low-income families through special single and multifamily community lending programs and through low-income housing tax credit investments which serve renters at 60% of median income or below.

Some system of analyzing and rewarding special efforts in serving lower income families, would help H.U.D. and Fannie and Freddie keep its public policy objectives from being a stepchild to the pressures of minimizing risk.

Conclusion

Fannie Mae and Freddie Mac have well performed their Congressional mandate. They have stepped in where the government has left off, and have made important efforts to reach low-income people not served through their conventional business. They have had a significant impact on both mortgage credit affordability and availability.

There is no need for a sudden change in their direction or regulations. H.U.D. and Congress have done a good job of oversight. It does not seem wise to urge that elimination of risk through a market driven triple-A standard should supersede the very Congressional mandate for which agency status was conferred.

Since Enterprise is so aware of the housing crisis besetting low-income people and neighborhoods, we urge H.U.D. to work in a reasoned, measured way with Fannie Mae and Freddie Mac to enhance the strong record of these companies. Whatever modifications are necessary can be carried out through constructive, ongoing regulation and discussion between H.U.D. and Fannie Mae and Freddie Mac. We urge H.U.D. to spend as much evaluation and analysis on the public purpose role of Fannie and Freddie as in the capital adequacy and risk-related matters.

Thank you.

STATEMENT OF

DAVID F. SEIDERS, PhD.

Before the

SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS

of the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

on

THE SAFETY AND SOUNDNESS OF FANNIE MAE AND FREDDIE MAC

August 2, 1990

Mr. Chairman and members of the Committee, I am David F. Seiders, Chief Economist and Senior Staff Vice President for Mortgage Finance and Housing Policy at the National Association of Home Builders' (NAHB). Prior to joining NAHB in 1984, I was Senior Economist at the Federal Reserve Board in the area of housing finance. In 1981-1982, I was Chief Policy Analyst for finance on the staff of President Reagan's Commission on Housing.

I am pleased to have this opportunity to appear before you to discuss the safety and soundness of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) and their roles in the mortgage credit markets.

Mr. Chairman, I want to commend you for holding this roundtable discussion at this time, particularly in light of the ongoing discussions among the Congressional Budget Summit participants and the Treasury of proposals to "reform" Fannie Mae and Freddie Mac. I also want to stress that we at NAHB think this Committee, and the discussion you are now holding, provide the most appropriate forum for any examination of concerns arising from Fannie Mae's or Freddie Mac's activities or financial condition. You and the members of the Banking Committee understand better than anyone else in Congress the increasingly critical role which Fannie Mae and Freddie Mac should be expected to play in our housing finance system in the wake of the thrift crisis and FIRREA. As the thrift industry continues to shrink, Fannie Mae's and Freddie Mac's role in providing mortgage money for homebuyers should continue to grow.

In addition to the need for Fannie Mae and Freddie Mac to take up the slack in the mortgage market left by the shrinking thrift industry, two other factors have in recent years led to an increased need for both enterprises. Those are:

- The government's retreat from housing programs in the 1980's. The need for housing programs did not decline along with the federal government's resolve and budget cuts. Rather, the market turned increasingly to Fannie Mae and Freddie Mac to provide a growing share of housing funds.

- Increasing demands on Fannie Mae and Freddie Mac to provide affordable housing programs.

Today, you have requested our input on several issues: 1) the capacity the Department of Housing and Urban Development (HUD) will need to conduct adequate oversight of Fannie Mae and Freddie Mac; 2) the potential impact of the Department of the Treasury's (Treasury) and the Office of Management and Budget's (OMB) proposals related to government sponsored enterprises (GSEs) on the ability of Fannie Mae and Freddie Mac to carry out their congressionally mandated missions; 3) the impact of the Treasury/OMB proposals on Fannie Mae's and Freddie Mac's ability to raise capital; and, 4) the advisability of separating program oversight of Fannie Mae and Freddie Mac from oversight of the agencies' safety and soundness.

Overriding these specific questions, however, is the broader question of Fannie Mae's and Freddie Mac's role in housing policy. Before addressing your specific questions, I will review Fannie Mae's and Freddie Mac's public purpose and the critical role they have played in U.S. housing policy.

PUBLIC PURPOSE OF FANNIE MAE AND FREDDIE MAC

Fannie Mae and Freddie Mac were created by Congress to play an integral role in federal housing policy by providing assistance to the secondary mortgage market. Since their creation in 1938 and 1970, respectively, Fannie Mae and Freddie Mac have evolved into critical components of this nation's housing delivery system. That we have become the best housed nation in the world is due in large part to the contributions Fannie Mae and Freddie Mac have made to that system.

In 1989, Fannie Mae and Freddie Mac supplied the funds for over half of all conventional mortgages originated. This represents a ten-fold increase over the 5 percent they supplied in 1980. Also, Fannie Mae has taken a number of innovative steps over the last several years aimed at providing more mortgage money for low- and moderate-income individuals, and Freddie Mac has embarked on an effort to do the same. Particularly in view of the significant shrinkage which is occurring in the thrift industry in the wake of FIRREA, it is clear that Fannie Mae's and Freddie Mac's importance in the mortgage market will only continue to grow.

Fannie Mae and Freddie Mac have, to date, succeeded in meeting these growing demands on their services by expanding the base of investors in mortgages and by reducing costs to the homebuyer. Fannie Mae and Freddie Mac have brought standardization to the mortgage market and have created liquid, safe, sound investments which appeal to traditional and nontraditional investors. Particularly notable is their work in developing an international market for U.S. mortgage investments. Today, Fannie Mae and Freddie Mac are able to tap both domestic and foreign capital markets for housing funds. Fannie Mae's and Freddie Mac's securities, and the secondary market they have supported, have become an important mechanism for disposing of the Resolution Trust Corporation's (RTC's) assets. As a consequence of the quality, standardization and liquidity brought to the mortgage market by Fannie Mae and Freddie Mac, costs to homebuyers have been reduced by about 50 basis points.

Pursuant to Congressional intent, Fannie Mae and Freddie Mac have always been there, through bad times as well as good. This includes the period in the early 1980's when interest rates soared, the refinancing boom of 1986-87, and the recent decline of the traditional mortgage provider in the market -- the thrift industry. Congress assured that Fannie Mae and Freddie Mac would always be there by providing them with a single purpose -- the provision and facilitation of residential finance.

Congress also provided Fannie Mae and Freddie Mac the means to accomplish their mission by granting them certain benefits or federal attributes, including exemption from SEC registration requirements and a $2.25 billion backstop line of credit to the Treasury which implies a federal guarantee. These represent two of the attributes which give rise to the market's perception of Fannie Mae's and Freddie Mac's "agency status," which in turn allows the entities to borrow at lower costs and have more favorable access to the credit markets. It should be noted that, although Fannie Mae has possessed its backstop line since 1954, it has never had to tap into its government line of credit, even in the early 1980's when a maturity mismatch in its balance sheet resulted in significant losses. Freddie Mac just received its Treasury line of credit last year in FIRREA, and never needed infusions of federal funds during its previous life as part of the Federal Home Loan Bank system.

Along with these federal benefits have come responsibilities and accountability. Fannie Mae and Freddie Mac are two of the most, if not the most, closely scrutinized corporations in the world. They are accountable to their shareholders as well as to the public through oversight by HUD, the Department of the Treasury, Congress and the President through his appointees to each of their Boards of Directors. Today's hearing serves as an illustrative example of Fannie Mae's and Freddie Mac's public accountability and testimony to the fact that the public-private partnership envisioned by Congress is working. Indeed, this hearing constitutes another step in the evolutionary process by which we create and maintain a reasoned, informed policy for the provision of affordable housing.

This hearing also provides testimony to Fannie Mae's and Freddie Mac's success in their housing mission. They have done precisely what they were created to do, and they have done it well, accounting today for over 50 percent of the conventional mortgage market, and over 80 percent of the loans conforming to the mortgage limits for Fannie Mae and Freddie Mac. Yet ironically, in the wake of the thrift crisis, this very success has raised fears by some that Fannie Mae and Freddie Mac could precipitate a new multibillion dollar bailout. This concern has resulted in a number of studies being conducted on the risks posed by Fannie Mae and Freddie Mac, and the adequacy of their capital.

CAPITAL ADEQUACY OF FANNIE MAE AND FREDDIE MAC

At the heart of the capital adequacy issue lies the question of risk. Large losses in the thrift industry have raised concerns about the risk posed to the federal government by GSEs like Fannie Mae and Freddie Mac. At the root of these concerns is the fear that the government would have to make good on the more than $600 billion of Fannie Mae's and Freddie Mac's outstanding debt and mortgage-backed securities.

Sheer size, in and of itself, does not constitute risk. To meaningfully evaluate the risks posed by Fannie Mae and Freddie Mac, one needs to analyze the credit and interest rate risk to which they are exposed and the measures they have taken to insulate themselves from those risks. As you know, over the past year a number of studies have been conducted to evaluate Fannie Mae's and Freddie Mac's risk exposure. At least three federal agencies -- Treasury, the General Accounting Office (GAO) and HUD -- have looked at this question. The Treasury and GAO studies were required by FIRREA.

In addition, Fannie Mae and Freddie Mac themselves have commissioned independent studies: Fannie Mae's was conducted by James O. Wolfensohn, Inc., under the direction of Paul Volcker, and Freddie Mac's was done by Price-Waterhouse. Importantly, each study concluded that Fannie Mae and Freddie Mac are adequately capitalized. Nevertheless, to ensure the long run good health of these entities, each study recommended that they increase their capital. Fannie Mae has already announced its intention to increase its capital by about $ 2.5 billion this year through an increase in retained earnings, which would boost its capital level by more than 50 percent.

TREASURY'S PROPOSAL FOR A TRIPLE-A RATING REQUIREMENT

Treasury took their recommendations at least one step further and recommended that specialized capital standards be developed for Fannie Mae and Freddie Mac that take into account their unique characteristics, and incorporate credit and interest rate risk for assets on and off the balance sheet. Lacking what it thought to be a suitable standard for Fannie Mae and Freddie Mac -- including HUD's debt-to-capital ratio requirement, bank and thrift risk-based capital rules, private mortgage insurers (PMI) standards, and Fannie Mae's and Freddie Mac's own tailor-made stress tests -- Treasury recommended that Fannie Mae and Freddie Mac, as well as all GSEs, be able to obtain a triple-A rating, absent any implicit government guarantee, from at least two private credit rating agencies. If Fannie Mae and Freddie Mac could not achieve a triple-A rating, Treasury recommended requiring them to submit a business plan to the Treasury Department which would enable the enterprise to obtain the rating within five years. Failure to meet this requirement would result in the GSE's forfeiture of its ties to the federal government.

Treasury recommended turning to the private rating agencies because this is where the private sector turns when faced with the need to measure and monitor risks. Treasury believes that this approach should be used to monitor GSE risk, as well. Further, Treasury states that "requiring this high credit standard should not increase the borrowing costs of any GSE, nor would it significantly impair the ability of GSEs to fulfill their public purpose."

Treasury's recommendations have now gone to the proposal stage. Treasury and OMB are in the process of circulating them among the Budget Summit members on the Hill. Additionally, OMB has recommended that fees or "risk premiums" be imposed by Treasury on any GSE which failed to obtain a triple-A rating. GSEs would have to obtain the triple-A rating within three months of enactment.

While we agree that Fannie Mae and Freddie Mac should always be adequately capitalized, we have several concerns about the Treasury and OMB proposals. It is not that NAHB fails to strongly support the safety and soundness of Fannie Mae and Freddie Mac. Quite the contrary. The question is one of approach and our analysis concludes that the Treasury/OMB proposal is not the proper approach.

First, we do not think it is appropriate to usurp the government's oversight authority by making the utility, and perhaps the survival, of these entities dependent upon private rating agencies. Moreover, it is not clear that entities in a single undiversified line of business, like Fannie Mae and Freddie Mac, could even qualify for a triple-A rating under the procedures of the rating agencies.

Most important, requiring Fannie Mae and Freddie Mac to take steps to meet a triple-A rating would have an adverse impact on the cost and availability of mortgage credit. Fannie Mae and Freddie Mac would not be able to fulfill public purpose elements of their charter if they had to shift operations to satisfy rating agency tests. They would be restricted from doing business in regions experiencing economic hardships, meeting special financing needs, and from nurturing mortgage market innovation. Attempts to raise capital by issuing stock, raising fees or shrinking their lending volume would put upward pressure on mortgage rates. The OMB-proposed penalties or "user fees" for failure to obtain the triple-A rating would put further upward pressure on rates and would be counterproductive to the ability of the entities to raise capital. Removal of the GSEs' federal attributes would be disastrous to Fannie Mae and Freddie Mac and would do irreparable damage to the mortgage market and the housing sector.

IMPACT OF TREASURY'S PROPOSAL ON THE HOUSING SECTOR, THE RESOLUTION TRUST CORPORATION AND THE ECONOMY

Impact on the Housing Sector:

The consequences which would befall the housing sector should either Fannie Mae or Freddie Mac fail to obtain their triple-A rating would be catastrophic. Not only would the housing mission of these agencies be seriously jeopardized, the role of the secondary market would be severely impaired. Here are some of the likely consequences, the effects of which would be immediately realized:

- Increasing home mortgage interest rates: In the fourth quarter of 1989, 86.3 percent of the dollar amount of non-government-insured conforming mortgages originated were financed by Fannie Mae and Freddie Mac. At present, there is no credit crunch in single-family end-loan mortgage finance as there is in the multifamily and housing production segments. Treasury's proposals could, however, create a credit crunch at least as severe as that currently occurring in these other segments.

- Undermining the availability of low down payment loans. We strongly believe that the rating agencies would raise the estimate of risk associated with low downpayment loans, which in turn would require Fannie Mae and Freddie Mac to put up more capital to back these loans.

- Inhibiting Fannie Mae's and Freddie Mac's ability to serve all areas of the country without interruption. Treasury's proposal would force lenders to use private conduits, which often seek to avoid buying loans in certain geographic locations.

- Restricting the ability of Fannie Mae and Freddie Mac to offer affordable housing programs and serve low-and moderate-income housing needs. The Treasury/OMB proposal penalizes any action the agencies would take to help low-income families afford housing. A ratings-driven and growth-constrained business will invest only in the lowest-risk product, which is not the reason Congress created Fannie Mae and Freddie Mac.

Impact on the RTC:

Rising mortgage rates would reduce the market value of Fannie Mae's and Freddie Mac's outstanding mortgage-backed securities (MBS), thus reducing the value of thrift assets and adding to the RTC's losses. In addition, by weakening the role of the secondary market, Treasury's proposal would restrict the ability of the secondary market to act as a conduit for the sale of mortgage assets presently under RTC control. Both of these occurrences would add to the already burgeoning cost of the savings and loan bailout and ultimately to the budget deficit.

Impact on the Economy:

The economy, is in a fragile state and any major shock could push it over the edge into recession. With housing starts at their lowest level since 1982, this proposal could be the shock that would topple the housing sector into a full-scale depression and push the economy into a recession.

We do not think it makes sense to subject the housing sector and the nation to these potential hardships, when all of the studies conducted thus far agree that Fannie Mae and Freddie Mac are well-managed and have taken prudent measures to control their risk exposure.

RISK MANAGEMENT AND CONTROL BY FANNIE MAE AND FREDDIE MAC

Fannie Mae and Freddie Mac have reduced their interest rate risk through simultaneous selling of mortgages purchased through their mortgage-backed securities (MBS) programs. In addition, Fannie Mae avoids interest-rate risk on its sizeable portfolio holdings by maintaining a close duration match between assets and liabilities. Freddie Mac employs a similar method for its smaller portfolio. (We note that due to mismatches in its portfolio, Fannie Mae experienced troubles in the early 1980s similar to those of the thrift industry. However, over the course of the decade, Fannie Mae took corrective action that has resulted in its current close duration match between its assets and liabilities.)

Fannie Mae and Freddie Mac have reduced credit risk through strict underwriting, quality control and seller/servicer criteria which have lowered default rates at both agencies. Indeed, HUD has noted that both Fannie Mae and Freddie Mac have lower default and foreclosure rates than the rest of the housing industry. Additionally, the geographic diversity of their mortgage purchases reduces exposure to adverse economic conditions in a single region of the country. For example, when the Southwest suffered economic distress, purchases from other regions served as a buffer.

Stress tests performed as part of the independent appraisals commissioned by Fannie Mae and Freddie Mac as well as those performed by HUD show that Fannie Mae and Freddie Mac are adequately capitalized to withstand the severest of economic conditions. Indeed, HUD's own stress test shows that Fannie Mae could survive wide interest rate swings over extended periods without serious financial problems.

HUD REGULATORY OVERSIGHT OF FANNIE MAE AND FREDDIE MAC

Capital Adequacy and Safety and Soundness

We believe that a sound approach to the question of Fannie Mae's and Freddie Mac's capital adequacy is outlined in HUD's recent studies of the two agencies. We agree with HUD that there is no need to rush to judgment on the capital issue and that additional capital and stress tests, combined with adequate monitoring, are the best ways to deal with the question of capital adequacy.

NAHB strongly believes that HUD is the appropriate Federal agency to oversee both the program responsibilities and the safety and soundness of Fannie Mae and Freddie Mac. We see no reason for the dual regulation called for under the Treasury proposal. The private sector rating agencies, which would be called upon under the Treasury's proposals to rate the GSEs, lack the housing and public policy-oriented expertise necessary to pass realistic judgments on Fannie Mae and Freddie Mac. In view of this dearth of relevant expertise, these rating agencies are simply not the appropriate entities for judging Fannie Mae's and Freddie Mac's financial health or performance.

The Treasury, similarly, lacks the housing expertise necessary to carry out an effective oversight function of Fannie Mae and Freddie Mac. Treasury's present regulatory function with regard to the housing-GSEs is to act as the Federal "traffic cop" for agency issues, coordinating Fannie Mae's and Freddie Mac's debt securities issuance with that of the Treasury's. There is no reason to expand their regulatory function beyond this.

Just last year, Congress through the Financial Institutions Regulatory, Reform and Enforcement Act (FIRREA) gave HUD oversight responsibility for Freddie Mac, in addition to Fannie Mae. Treasury lacks the housing expertise which is the very essence of HUD, and such expertise is essential for adequately judging the performance of the housing GSEs. Indeed, it is precisely for this reason that Congress placed regulatory oversight of Fannie Mae and Freddie Mac with HUD.

We applaud HUD's recognition of Fannie Mae's and Freddie Mac's housing mission, as reaffirmed in HUD's recent reports on the agencies, and the acknowledgment that "the need for adequate capital must be balanced against other objectives such as the public mission of the agencies. Accomplishing their public policy objective of a well-functioning secondary mortgage market necessarily requires some degree of risk-taking on the part of the agencies. . . . The task now is how best to reconcile the agencies public-policy objectives with concerns with their safety and soundness."

We commend Secretary Kemp for the recent establishment of the Financial Institutions Regulatory Board (FIRB) within HUD to incorporate the agency's regulatory responsibilities for Fannie Mae and Freddie Mac within the Department's overall regulatory structure. We understand that FIRB will be charged with assisting HUD in regulation of Fannie Mae and Freddie Mac and in achieving the balance between public purpose and safety and soundness. To accomplish its mission, FIRB will monitor Fannie Mae and Freddie Mac through economic stress testing and periodic reports on the enterprises' exposure to interest rate and credit risks.

In principle, we believe that a reasonable stress test is a superior method for monitoring capital adequacy than other methods which have been suggested by GAO and others. We agree with HUD (and Treasury) that bank and thrift risk-based capital standards are not appropriate capital standards for Fannie Mae and Freddie Mac because of the significant differences in the nature of these GSEs' business and that of banks and thrifts. Fannie Mae and Freddie Mac have a national presence and are better diversified geographically than banks and thrifts; Fannie Mae and Freddie Mac are restricted by statute to residential finance and cannot expand into other forms of lending; they have broad access to the capital markets; and, substantial guarantee fee income. All of these factors are ignored by the bank and thrift risk-based capital rules.

However, we do not believe that economic stress tests should be used as an exclusive measure of capital adequacy. Results of stress tests should be balanced against internal management and risk control measures (such as underwriting, quality control and seller/servicer criteria) which both entities employ to reduce their risk exposure.

The financial models which HUD plans to develop and employ in these stress tests should account for the unique characteristics of these entities. For example, we note HUD's intention to evaluate Fannie Mae's and Freddie Mac's MBS operations as a private mortgage insurance business and to develop a financial model similar to Moody's Great Depression stress test to examine the interest-rate risk of the MBS operations. While we agree that this is probably the best structure to use, the parameters of the model should account for the differences between PMIs and Fannie Mae and Freddie Mac. The principal difference is that on high LTV loans, such as those above 80 percent loan-to-value (LTV), the PMI is the primary insurer while Fannie Mae and Freddie Mac are the secondary insurers, having already obtained private mortgage insurance on the loans. Additionally, high LTV loans are the only loans in a PMI's portfolio, while Fannie Mae's and Freddie Mac's portfolios and guaranteed pools contain lower LTV, less risky loans. In 1989, the average LTV on loans insured by PMIs was 89 percent, while the original LTV of Fannie Mae's and Freddie Mac's outstanding portfolio and MBS was 72 and 80 percent, respectively. For these reasons, Fannie Mae's and Freddie Mac's risks are lower than those undertaken by PMIs.

Most important, the implications of the stress tests should be balanced against Fannie Mae's and Freddie Mac's housing mission. Excessive capital requirements based solely on the results of the stress tests could impair the ability of these entities to perform their housing mission.

Low- and Moderate-Income Housing Programs

Last year, in the restatement of Fannie Mae's and Freddie Mac's statutory purpose, FIRREA stipulated that part of Fannie Mae's and Freddie Mac's public purpose is to provide ongoing assistance to the secondary market for residential mortgages securing housing for low- and moderate-income families at a reasonable economic return to the entities. FIRREA also gave the Secretary of HUD the discretion to require that a fixed percentage of mortgage purchases be devoted to mortgages secured by housing for low- and moderate-income families.

We believe that Fannie Mae already does a commendable job in the area of affordable housing. It played a key role in providing housing to low- and moderate-income families long before it was required to do so by FIRREA. Moreover, the average mortgage purchased by these entities has traditionally been significantly below their statutory limit. For example, in 1989 while the limit for their mortgage purchases was $187,600, the average 1- to 4-family mortgage purchased by both Fannie Mae and Freddie Mac was $83,000. Nearly 20 percent of the loans purchased by Fannie Mae were below $40,000 and one-third of those purchased by Freddie Mac were below $60,000. Additionally, each has established low-income housing programs as an ongoing part of their businesses.

In 1987, Fannie Mae created an Office of Low- and Moderate-Income Housing. This office is responsible for creating and managing Fannie Mae's current low- and moderate-income housing initiatives and for creating additional ones. Since the office was created, Fannie Mae has committed to invest about $4.0 billion in these activities. This includes the purchase of roughly $2.2 billion of mortgage revenue bonds through its public finance programs which has provided affordable financing for an estimated 37,000 low- and moderate-income families. The commitment to purchase $900 million in single-family mortgages that will serve 15,000 low- to moderate-income homebuyers through more than 30 community lending programs throughout the nation. And, more than $150 million in low-income housing equity investments that qualify for federal low-income tax credits. These projects, located throughout the country, will provide financing for more than 8,000 units of affordable rental housing for low-income families, for the elderly and for formerly homeless people.

Freddie Mac, we are pleased to say, has also been active in developing single-family affordable housing programs aimed at lower-income individuals, and recently launched a broader scale effort in this area. Under its new Affordable Housing Initiatives Department, Freddie Mac announced last month a $500 million public-private partnership with the state of Michigan that will provide more than 10,000 families with access to mortgage financing that might not otherwise be available to them by modifying underwriting and servicing guidelines, providing homebuyer education and counseling, sharing of credit risk, and involving community groups. Freddie Mac hopes that this program will serve as a prototype for similar programs in other states.

In summary, we believe that Fannie Mae and Freddie Mac have been on the cutting edge of innovative financing efforts in the area of affordable housing. They have demonstrated the initiative to develop and to implement a multitude of programs to foster homeownership and rental opportunities for lower-income individuals. Thus, while HUD should fulfill its monitoring responsibilities in this area, we do not expect that it will be necessary for HUD to place strict requirements on the agencies performance in the affordable housing area.

Specifically, we urge HUD not to require that a fixed percentage of the agencies' purchases be secured by housing for low- and moderate-income families. Because these loans are often riskier than other loans, and Fannie Mae and Freddie Mac are charged with achieving an adequate return on such transactions, Fannie Mae and Freddie Mac should be given considerable flexibility to achieve their charge to serve low- and moderate-income families. A rigid requirement for low-income housing activity levels could unnecessarily increase the overall risk exposure of the agencies. Participation in the affordable housing market must be balanced against the risk. The agencies have taken precautions to reduce their risk exposure in the programs they have developed by requiring, for example, soft seconds and private mortgage insurance.

We recommend, then, that HUD maintain careful monitoring of the agencies' activities in the area of affordable housing to insure that they are meeting reasonable social goals as well as the requirements of FIRREA, but specific requirements seem premature.

CONCLUSION

In closing, let me reiterate that NAHB strongly supports the financial safety and soundness of Fannie Mae and Freddie Mac, but we oppose unnecessary and excessive regulation which would impede the ability of these entities to perform their housing mission. For the housing industry, the Treasury's efforts to overhaul the financial underpinnings of Fannie Mae and Freddie Mac could not come at a riskier time. You have in recent weeks participated in hearings held by the Banking Committee on the growing credit crunch, so I do not need to tell you what current market conditions are doing to the housing industry. To now impose an unrealistic rating system on Fannie Mae and Freddie Mac, which is sure to significantly increase mortgage interest rates, would just about break the back of housing. We urge you to oppose the Treasury's proposals, and to continue in your own efforts to judiciously oversee the activities of Fannie Mae and Freddie Mac. Indeed this very hearing bears witness to the amount of scrutiny to which Fannie Mae and Freddie Mac are already subjected, without adding Treasury and other Congressional committees to the process.

Finally, I just want to add that, in the tumult of thrift restructuring this is not the time to be reining in Fannie Mae and Freddie Mac with calls for triple-A ratings which could have a potentially devastating impact not only on these institutions, but on the entire housing sector. Instead, we believe it is time for caution and study. This is why we agree with the reasoned approach recommended by HUD: additional capital and stress tests combined with adequate monitoring. Fannie Mae and Freddie Mac have done an exemplary job in balancing their risks against their public purpose. We hope that the current debate will emphasize this balance.

For Release on Delivery
Expected at 2:00 PM
August 2, 1990

STATEMENT OF
CAROLE S. BERGER
SENIOR VICE PRESIDENT
C.J. LAWRENCE, MORGAN GRENFELL INC.
BEFORE THE SUBCOMMITTEE
ON HOUSING AND URBAN AFFAIRS

Mr. Chairman and Members of the Subcommittee,

I am pleased to be here today to discuss my views on the safety and soundness and capital adequacy of the Government-Sponsored Entities (GSEs), more specifically, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. As an equity analyst specializing in commercial banks and other financial institutions for the last 15 years, I embrace the concept of safety and soundness of well-capitalized financial institutions. I therefore commend you for seeking appropriate measures to ensure the viability of these enterprises. I am disturbed, however, with several of the issues related to the current Treasury/OMB proposals regarding Fannie Mae and Freddie Mac.

Underlying their proposals appears to be a concern that a corporation with shareholders requires undue risk-taking and that such risk taking would eventually, in the case of a GSE, necessitate a federal bailout. Further, it is assumed that because of their link to the government, there is no "market discipline" imposed on these companies. I disagree strongly with this line of reasoning. Maximizing shareholder value over the longer term requires the management and pricing of risk, not the avoidance of risk.

Further, I find the Treasury proposals that GSEs maintain a triple-A status or face sanctions imposed by the Treasury inappropriate and impractical.

Lastly, I would encourage you to refocus your attention on the missions Congress has set forth for the GSEs. Any changes to their structures or their ability to tap the capital markets will affect their capacity to carry out those missions. Each was chartered to fulfill a role in the financial system that private companies couldn't or wouldn't provide on a cost-effective basis to the public. I urge you to study the potential costs of these agencies versus the benefits they provide.

Stockholder-Owned Is Not Synonymous with Risk

Managers of financial institutions recognize that maximizing shareholder value requires careful balancing of risk and reward. Shareholders do not buy the stock of a company that they perceive is generating short-term profits while placing the longer-term viability of the institution at risk. Shareholders of financial companies pay a premium for those companies which provide a competitive return on their investment while also minimizing the risk. That is, investors would rather see a stable return on their investment over an extended period of time than quick short-term profits followed by a loss of their capital. The return on investment must remain competitive with those of other companies tapping the capital markets to ensure access to the markets at a reasonable cost when funds are required.

In order to achieve this, a manager must understand the risks inherent in his business and be able to price his product (loans and investments) in order to generate a reasonable rate of return to shareholders while building reserves and capital sufficient to guard against potential losses. If a company is overcapitalized, it either needs to raise the price of its products or its returns on investment will fall.

Balance sheet management is also an integral part of such management. Not only is it important to build capital and reserve, but it is equally important to reduce balance sheet risk through careful asset-liability management. Occasionally, this asset-liability management necessitates giving up short-term profits to achieve long-term stability of returns. I can think of at least two examples when the management of Fannie Mae chose to forgo earnings in order to reduce balance sheet risks, resulting in more stable future earning streams.

- In 1986, management chose to sell $10 billion of assumable mortgages at no material gain or loss. Assumable mortgages are harder to match-fund on an asset-liability basis and might potentially have been unprofitable in future years when interest rates rose. At the time management made the decision to sell them, they had no way of knowing whether interest rates would go up, down, or sideways. But understanding the risks, management decided to forgo the interest income these loans would have provided, in the then-hospitable interest rate environment, to reduce the potential risk. When they sold the $10 billion of mortgages, those assets had a yield of 9.74%, roughly 180 basis points above their average cost of long-term debt issued that year. In other words, Fannie Mae chose to give up roughly $180 million of annual income in order to reduce the risk to the balance sheet. On an after-tax basis, earnings available to shareholders that year were essentially cut in half by this risk-reduction technique. Over the course of that year, the share price rose 57.5%, as investors were willing to pay a greater sum for less earnings because of the better quality and diminished risk of that income stream.

- Fannie Mae has in the last 12 months taken further steps to reduce interest rate risk through the issuance of callable debt. Callable debt sells at a premium to noncallable debt. However, it protects the borrower from interest rate risk in the event that interest rates were to fall. When mortgage rates drop, many homeowners prepay their mortgages. Without callable debt, Fannie Mae would lose a high-yielding asset but still be paying a high-rate debenture. Callable debt helps limit this problem but at a current cost. In the last 12 months, Fannie Mae has issued $9.4 billion of callable debt. I estimate that they have given up between $28 and $48 million of income these last 12 months in order to reduce interest rate risk. I believe, that just as in 1986, shareholders will benefit in the longer term from this reduced risk and, therefore, accord a higher price-to-earnings multiple to lower earnings.

These are just two examples of ways in which Fannie Mae's management has forgone income to reduce balance sheet risk. There are many more. They have built, and continue to build, capital and reserves at a rapid pace. It is true that shareholders have benefited, but so too, have homeowners and taxpayers. Fannie Mae today presents far less risk to the U.S. taxpayer than it did in the early 1980s, when the new management brought market disciplines to bear. They have shown that shareholders' interests are not at odds with the U.S. taxpayers' interests. Investors seek a reasonable rate of return for the use of their capital and pay a premium for reduced risk.

Treasury Proposal for Triple-A Ratings for GSEs

I believe the Treasury's current proposal to have GSEs obtain triple-A rating from two major U.S. bond rating agencies is inappropriate (for it abrogates the government's fiduciary responsibility) and impractical (for it is a standard that no private-sector financial institution has been able to achieve). Not even J.P. Morgan & Co. is rated triple-A by both Moody's and Standard & Poor's.

Adopting this triple-A proposal would endow those rating agencies with powers to influence public policy. This goes far beyond the scope of those agencies. They exist as private-sector companies that get paid to provide a service to bondholders, helping them judge the credit quality of fixed-income securities. While commercial banks' fixed-income securities are rated by the agencies they are regulated on either a national or a state level. The rating agencies are not the final arbiters of the safety and soundness of the banking industry. Neither should they be the arbiters for the GSEs.

At the time the triple-A rating was proposed by the Treasury, the officials indicated that no "single capital adequacy test or standard can or should apply to all GSEs due to the diversity and complexity of their operations." The Treasury found itself unable to define "adequate capital" for each of these GSEs. The same Treasury officials would now like us to believe that although they do not have expertise to define adequate capital, they would have the expertise to mandate changes to these Boards of Directors and managements and to correctly guide these institutions' financial management through other sanctions, such as capping dividends or asset growth in order for them to meet this target they themselves cannot define. I find inconsistencies in their logic.

Commercial banks consistently strive to maintain superior bond rating. The higher the bond ratings, the lower their cost of capital and, therefore, the more profitable their lending business. This is the market discipline we hear about so often that some feel it is missing in the GSEs. In theory, that might be true; in practice, it is hardly ever achieved. In spite of the strong incentives for bank managers to have superior ratings, only one, J.P. Morgan & Co., is rated triple-A, and even they are rated triple-A by only one of the agencies.

Is it practical to set a target for our GSEs that cannot be met by the best private-sector financial institution? I believe the answer is no. Inarguably, triple-A is the least risky. But this gets back to my first point, the balancing of risk and reward. In the case of the GSEs we are talking about the potential risk to the U.S. taxpayer of a failure of one of these entities versus the benefit or cost savings to the constituency that agency serves (housing, education, and/or agriculture). The Treasury, by their own admission, has not made this a part of their proposal, nor have they taken into account the Congressional intent for each GSE, nor have they done cost/benefit analyses to see that the benefits pass through to their targeted beneficiaries.

Mission of the GSEs

As I alluded to in my opening remarks, each of the GSEs was chartered to fill a void in the U.S. financial system. Today, to my knowledge, most fulfill their mission with little risk to U.S. taxpayer. It is my observation the GSEs where there is a marriage of public and private interests (i.e., stockholder-owned GSEs) operate in a less risky manner. In fact, their shareholders' equity has in stressful times buffered the U.S. taxpayer from loss. In the early 1980s, when Fannie Mae was losing money, it was the stockholders who suffered, not the taxpayers.

Fannie Mae, in particular, has not only rewarded its stockholders, it has accomplished this as it fulfilled its mission as dictated by its Congressional charter. The credit-quality standards of Fannie Mae and Freddie Mac have, in my opinion, diminished the risk to the U.S. housing markets. Private-sector banks and thrifts would likely have continued writing high loan-to-value ratio loans (as they did in the Southwest) were it not for the fact that these agencies brought standardization and a credit superstructure to the housing finance market. It can be shown that high loan-to-value loans result in higher default risk. That is, in good times, a bank might lend 90% to 95% of the appraised value of a home, but when economic conditions change, the homeowner might find himself overburdened by debt, unable to make mortgage payments, and ultimately, his property would have to be foreclosed on. Recognizing this default risk, the housing GSEs have fostered better, sounder credit policies by their mere existence. They are not significant purchasers of these high loan-to-value mortgages, therefore, banks and thrifts are reluctant to write vast numbers of them. Ultimately, it is the homeowner, who bought his home on a sound financial basis, who benefits. Not only do I think they have reduced default rates nationally, I also believe they have lowered mortgage rates to the homeowner.

These agencies have standardized mortgage securities, making them more salable to institutional investors in the form of mortgage-backed securities. Without the housing agencies, these sources of funds would have been much harder to tap. It is difficult to measure, but I believe that the existence of these agencies lowers mortgage rates in the U.S. As a financial analyst, I know that the more efficient a capital market, the lower the cost of capital. Simply stated, the more capital flowing into the asset class, the lower the interest rate on that asset. The requisite of a healthy secondary market is a standardized product. Fannie Mae and Freddie Mac provide that standardization, as well as a credit-quality framework which has enabled the growth and proliferation of the mortgage-backed securities markets. The new capital flows available for mortgage investment over the course of the 1980s have, in my opinion, lowered mortgage rates in the U.S. Without the growth of this capital market, banks and thrifts would either have had to fund that growth on their already capital-constrained structures, possibly charging more for them, or the loans might not have been made at all.

Conclusion

In summary, before you, Congress, change or alter the structure of these GSEs I urge you to commission studies which incorporate some sort of cost/benefit analyses. In the course of this testimony, I hope I have not given you the wrong impression. I believe in a responsible regulatory environment. Indeed, you may decide that further regulatory scrutiny of GSEs is desirable. You may also conclude that higher capital ratios are desirable. However, I believe that the Treasury's triple-A proposal is insufficient and shortsighted. By their own admission, the Treasury has not done any cost/benefit analyses, nor tried to determine the possible impact of their proposal as it pertains to the missions of GSEs. I believe it borders on irresponsibility for the Treasury to suggest such legislation before these issues are studied. The proposal tries to take a broad-brush, impractical approach to entities providing credit to the very different, specialized markets of agriculture, housing, and higher education.

Thank you for your attention. I will be pleased to answer any questions.

CUSHING N. DOLBEARE
Consultant on Housing and Public Policy
215 Eighth Street, Northeast
Washington, DC 20002-6105
202 544-5505

STATEMENT FOR SENATE BANKING COMMITTEE ROUNDTABLE ON
SAFETY AND SOUNDNESS OF FANNIE MAE AND FREDDIE MAC
AUGUST 2, 1990

My name is Cushing N. Dolbeare. I am the founder and current Chairperson of the National Low Income Housing Coalition. I am also, for the remainder of this year, interim Executive Director of the National Coalition for the Homeless. I have been a full- or part-time Consultant on Housing and Public Policy from 1971 to the present. My primary activities have focussed on analysis of low income housing needs and programs at the national level; analysis of federal budget and economic policies, primarily as they relate to low income needs; and lecturing and speaking on housing and low income issues.

I appreciate the opportunity to appear at this roundtable to express the interest and concern of both the National Low Income Housing Coalition and the National Coalition for the Homeless that the activities of Fannie Mae and Freddie Mac be encouraged, as far as feasible, to advance and augment efforts to provide housing for low income and homeless people. My comments will focus on Fannie Mae, with which I am more familiar, but I believe they are applicable to Freddie Mac as well.

The federal government clearly has two basic roles with regard to housing. The first is creating economic climate and institutional framework to let private sector function effectively. The second, to which I have devoted most of my career, is to provide the assistance necessary to meet the housing needs of very low income people, which cannot be done by the private sector (or by state and local governments) without substantial federal subsidies.

Occasionally it is important to state the obvious: the need for federal housing subsidies is lessened to the extent that the private sector is able, or is enabled, to meet low income housing needs. FNMA has been doing this in two ways, by directly assisting in the financing of subsidized low-income housing and by financing unsubsidized housing for moderate income families, thereby relieving some of the housing pressures on low income households.

We should not let the appalling cost of the savings and loan bail-out traumatize us into a single-minded focus on reducing the risk or exposure of the federal government to further costs to the extent that valuable and relatively low-risk programs and activities are curtailed or terminated without consideration of the need for and benefits of these activities.

Nor is it prudent to base public policy on "worst-case" scenarios, such as the recurrence of an economic disaster such as the depression of the 1930's. We know far more than we did then about how to avoid such cataclysms, and our actions should be based on implementation of what we already know, not on shielding us from the consequences of failing to act.

To help set the context for specific decisions about the future of Fannie Mae and Freddie Mac, I have included in this statement several charts on low income housing needs and federal housing expenditures. Clearly, the committee is aware of these overall patterns. Nevertheless, the specifics are so dramatic that they bear review.

Rental Affordability Crisis, 1970-90 compares the number of households in the bottom quartile of renters, and the number of units they can afford, using gross rents of 30% of the upper threshold as the standard of comparison. In 1990 constant dollars, the bottom quartile of renter households had incomes below $10,058 in 1970, meaning they could afford no more than $251 monthly for rent and utilities at the 30% standard. There were 5.9 million renter households in the bottom quartile, and 6.6 million units costing $251 or less in the inventory, leaving a bit of elbow room. (These figures should not, however, be taken to indicate that the supply of low income housing was adequate: it ignores the key factors of availability, quality, and size.

This year, assuming my projections are more or less correct, there are 8.5 million renter households in the bottom quartile, with incomes below $9,683, but only 4.3 million units costing less than $242 monthly. In other words, instead of the 1970 ratio of roughly one low income unit per household, there are two households for every low income unit.

It should be noted that this occurred in spite of the fact that the number of subsidized rental units trebled between 1970 and 1980, from about 1 million to about 3 million, and it has increased by 50% since 1980, to roughly 4.5 million.

Renter Households by Income, 1987, and Amount Affordable at 30% of Income uses recently published 1987 American Housing Survey data, which shows that one renter household in eight can afford no more than $125 monthly for rent and utilities, using the 30% of income standard. Roughly one in three can afford no more than $250 monthly.

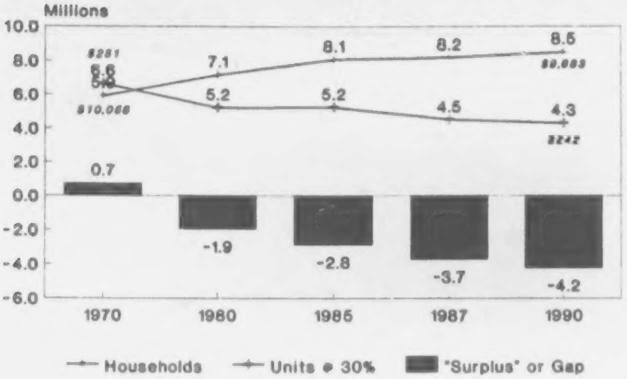
Subsidized and Unsubsidized Renters by Income, 1987 and **Subsidized and Unsubsidized Renters by Monthly Housing Cost, 1987** show that only a small proportion of low income households are assisted by federal housing programs, and, except for units costing less than $100 monthly, most low-cost units are also unsubsidized.

Federal Spending for Housing, 1976-91 contrasts the three major forms of federal spending: tax expenditures, budget authority, and outlays. While outlays have risen only gradually and budget authority has been slashed (the one-year peak in 1985 is because of shifting the financing of public housing from loans to capital grants, which added no additional units), tax expenditures have soared and have consistently dwarfed other housing subsidies. **Housing, All Low Income, and Total Outlays** places federal outlays for housing and other low income programs (primarily food stamps, Medicaid, housing assistance and other targeted income security programs) in the context of total federal outlays. It was not until 1981 that federal outlays for housing assistance reached even 1% of the federal budget.

Because the bulk of federal housing spending is through tax expenditures, which primarily benefit upper income households, the overall pattern of federal spending for housing is badly skewed. The two charts on **Estimated Housing Subsidy Distribution by Household Income Quintile, FY 1991** show, first, the overall distribution of housing subsidies and, second, the split between direct and tax subsidies in each quintile. Significantly, if these estimates are correct, in FY 1991, the bottom quintile would receive about 13% of all housing subsidies and the next two quintiles together would get only 11%, while the top quintile would get 60% of total subsidies. This shortchanges not only very low income households, those with the greatest needs, but also middle income households -- those whose homes are frequently financed through Fannie Mae and Freddie Mac.

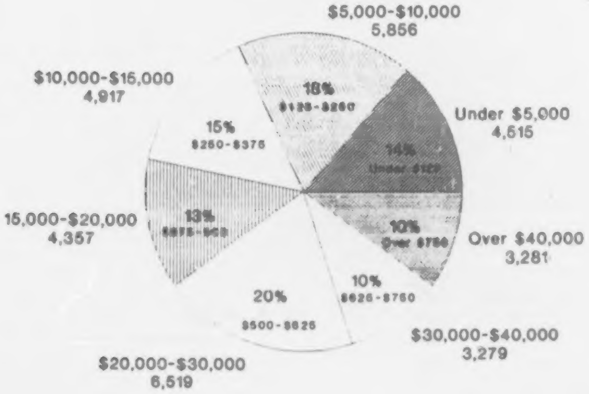
This pattern of needs and expenditures supports the basic premise that it is both necessary and appropriate for the federal government to avoid curtailing either secondary market activities which underlie much of the availability of financing for middle income families or the special programs to facilitate the provision of low-income housing, in combination with other public and private efforts.

RENTAL AFFORDABILITY CRISIS, 1970-90
Bottom quartile of renter households
and units at 30% of income threshold



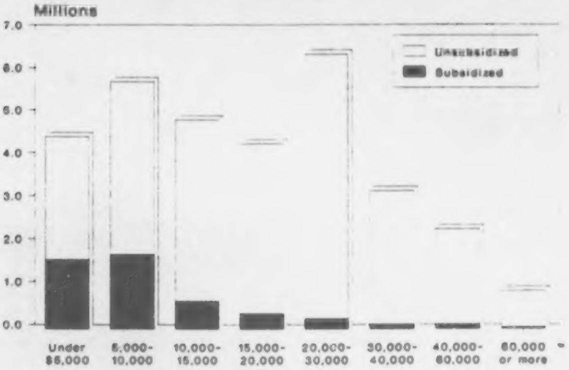
1990 figures are projections (1990 $)

RENTER HOUSEHOLDS BY INCOME, 1987
AND AMOUNT AFFORDABLE AT 30% OF INCOME



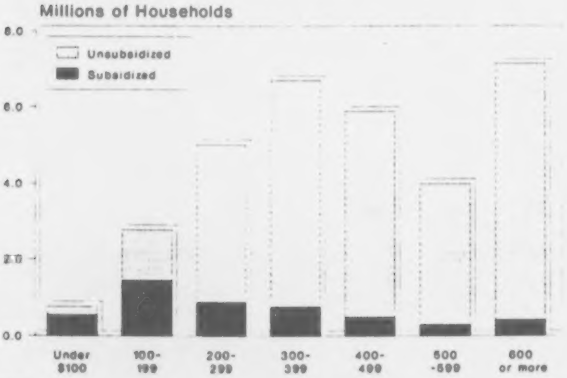
Thousands of households

SUBSIDIZED AND UNSUBSIDIZED RENTERS BY INCOME, 1987



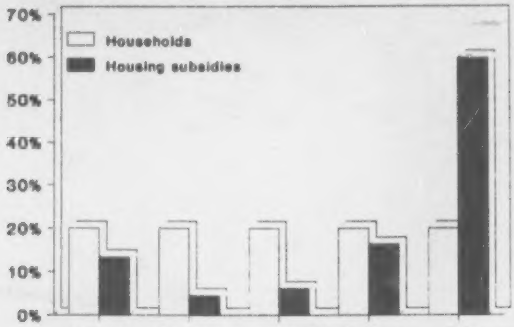
	Under $5,000	5,000-10,000	10,000-15,000	15,000-20,000	20,000-30,000	30,000-40,000	40,000-60,000	60,000 or more
Unsubsidized	2.9	4.1	4.2	3.9	6.2	3.1	2.2	0.9
Subsidized	1.6	1.7	0.6	0.4	0.2	0.1	0.1	0.0

SUBSIDIZED AND UNSUBSIDIZED RENTERS BY MONTHLY HOUSING COST, 1987



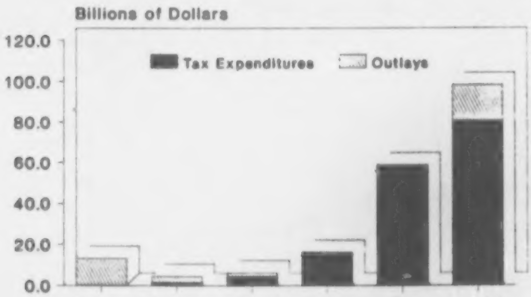
	Under $100	100-199	200-299	300-399	400-499	500-599	600 or more
Unsubsidized	0.2	1.3	4.1	5.9	5.4	3.7	6.7
Subsidized	0.5	1.4	0.9	0.8	0.5	0.3	0.4

ESTIMATED HOUSING SUBSIDY DISTRIBUTION BY HOUSEHOLD INCOME QUINTILE, FY 1991



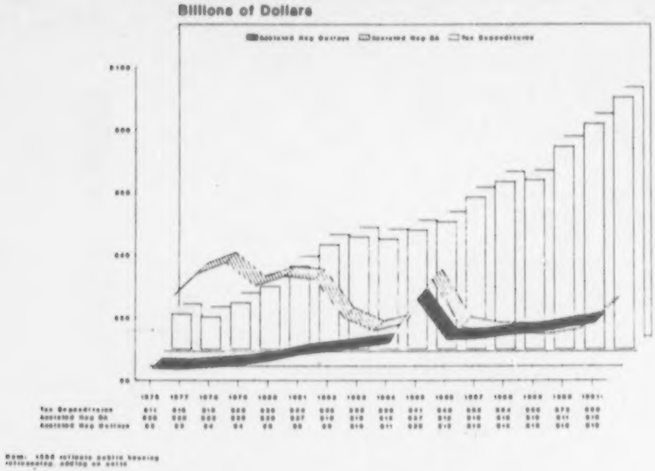
	Lowest	Second	Third	Fourth	Top
Households	20%	20%	20%	20%	20%
Housing subsidies	13%	5%	6%	16%	60%

ESTIMATED HOUSING SUBSIDY DISTRIBUTION BY HOUSEHOLD INCOME QUINTILE, FY 1991

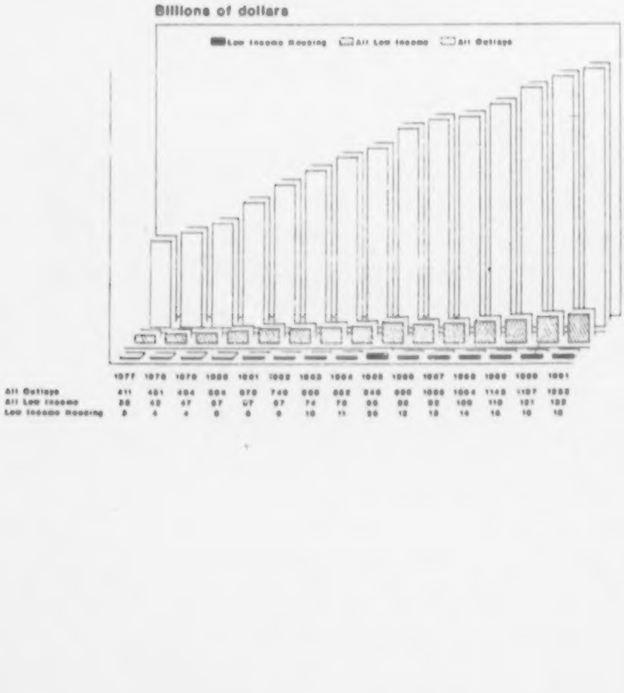


	Bottom Quintile	Second Quintile	Third Quintile	Fourth Quintile	Top Quintile	Total
Total	13.1	4.4	6.0	16.0	58.5	98.0
Outlays	12.9	3.2	1.6	0.0	0.0	17.7
Tax Expenditures	0.2	1.2	4.5	16.0	58.5	80.3

FEDERAL SPENDING FOR HOUSING, 1976-91



HOUSING, ALL LOW INCOME, AND TOTAL OUTLAYS



CONGRESSIONAL BUDGET OFFICE
U.S. CONGRESS
WASHINGTON, D.C. 20515

Robert D. Reischauer
Director

July 20, 1989

Mr. John Kriz
Vice President - Financial Institutions
Moody's Investors Service
5th Floor
99 Church Street
New York, NY 10007

Dear John:

The Department of the Treasury has proposed that government-sponsored enterprises (GSEs) obtain credit ratings from private rating agencies. The agencies would be directed to ignore the GSEs' ties to the government. The Congressional Budget Office (CBO) is interested in providing the Congress with information about how the rating agencies could help the government implement this proposal or others that would rely on the rating agencies.

To that end, I am writing to invite representatives from Moody's Investors Service to come to CBO on Wednesday, August 1 to discuss relevant issues with interested Congressional staff. I anticipate that CBO and Congressional staff would be interested in discussion the following topics:

- How can Moody's ignore the implicit federal guarantee? Do you perform similar analytical exercises as part of the services provided to wholly private firms? Is a rating assigned to a GSE absent the government guarantee strictly comparable to the publicly available ratings of wholly private firms?

- How does Moody's assess the various risks of each GSE? What quantitative and qualitative techniques do you use for GSEs that have different lines of business (portfolio lenders versus financial guarantors, for example), that operate in different sectors of the economy, and that have different organizational structures?

- If Moody's has already rated the GSEs absent their ties to the government, what are the ratings?

- How significant are the differences between various investment-grade ratings, e.g., between triple A and triple B? How significant is the difference between investment-grade ratings (triple B and above) and noninvestment-grade ratings (double B and below)? Are these differences quantitative or qualitative? (I have multiple copies of the April 1990 Moody's study on bond defaults and will make them available at the session.)

- Does Moody's have criteria that firms must satisfy in order to obtain particular ratings, e.g., triple A? Could you give criteria for different ratings that the government could use in creating business plans for GSEs?

As we discussed by phone, the discussion would be informal and off the record. Staff from the House and Senate budget, banking, education, agriculture, and tax-writing committees would be invited. Representatives from Moody's would not be expected to divulge any information provided in confidence by any GSEs. Nonetheless, you could expect specific questions about the risks of particular GSEs and your means of assessing those risks.

I look forward to working with Moody's on this matter and to hearing from you.

Sincerely,

Robin Seiler

Robert S. Seiler, Jr.
Principal Analyst

Responses to Questions Posed by the Congressional Budget Office to Moody's Investors Service on the Appropriateness of Ratings in the Regulation of U. S. Government-Sponsored Enterprises

August 1, 1990

Kenneth J. H. Pinkes
Vice President
Director - Financial Institutions Group

Christopher T. Mahoney
Associate Director - Vice President
Financial Institutions Group

John J. Kriz
Vice President
Financial Institutions Group

Douglas Lucas
Assistant Vice President
Structured Transactions Group

James Schmidbauer
Senior Analyst
Structured Transactions Group

Moody's Investors Service
New York City

Question #1 How can Moody's ignore the implicit federal guarantee? Is a rating assigned to a GSE absent the government guarantee strictly comparable to the publicly available ratings of wholly private firms?

Moody's can ignore the implicit federal guarantee of GSE debt in assigning ratings. However, in doing this, we would necessarily be forced to make arbitrary assumptions. Furthermore, we would need to know precisely what is meant by the concept "government support" if it is to be treated as a controlled variable. This government support, in Moody's view, is a complex fabric of political interests and institutions, public policies, and legal relationships. For example, in the requested "stand alone" rating analysis, should we ignore GSEs' statutory lines of credit with the U.S. Treasury? Broad federal support for agriculture, housing or education? Past GSE assistance? Federally appointed GSE board members? Current federal regulation and Congressional oversight of GSEs? Public purpose activities? Tax exemptions? Answers would be needed to these questions.

- A GSE's federal relationship is integral to its existence and character. Federal government support for a GSE is a facet of the mosaic of factors we look at in determining credit quality. This mosaic also includes such factors as management strength and risk appetite, operational and risk controls, asset quality, liquidity, strategic market position, industry structure, and profitability strength and breadth.

- "Stand-alone" GSE ratings, sophisticated though they might seem, would not be strictly comparable to other ratings because they would be based on arbitrary assumptions. It would be hard to give assurance that the default likelihood associated with, say, a "double-A" rated firm would bear a close resemblance to the default likelihood of a "double-A" rated GSE, should the GSE rating be derived while ignoring the federal relationship.

- By assuming the withdrawal of federal support, a host of characteristics of the GSE, such as its industry position, the structure and profit dynamics of its industry, its product mix and capital structure, and its pricing strategies, among other things, would be fundamentally changed. These real-life characteristics would have to be replaced by "new" characteristics that, by their very nature, would be purely hypothetical. Our rating conclusions would be sensitive to the precise assumptions made.

- A rating agency could perform a liquidation analysis of a GSE at a particular point in time to try to determine the GSE's solvency. This method assumes that the GSE stops booking business and simply liquidates itself over time in an orderly manner. If the GSE has positive equity at the end, it can be said to be "solvent". One can also utilize this analysis to determine the magnitude of the solvency cushion. This approach is also sensitive to the assumptions made. Liquidations are rarely, if ever, orderly. While all credit analysts would agree that a point-in-time liquidation analysis -- or a market-to-market analysis of a firm, or a stress-test analysis -- can provide useful information, this information should only be used as part of the mosaic of credit factors spoken of above. This is because liquidation analyses can be misleading if used alone.

Question #1 cont. Do you perform similar analytical exercises as part of the services provided wholly private firms?

No, we don't believe so. We are only experienced in determining the long-term default likelihood of fixed income securities. In this single task rating agencies have been successful. For example, Moody's study of bond defaults indicates that ratings provide accurate, long-term indications of the likelihood of default, with the likelihood of default being a close, inverse function of the initial rating (i.e. low-rated bonds default more often than high-rated bonds). Rating agencies have no similar track record as consultants or as advisors.

Question #2 How does Moody's assess the various risks of each GSE? What quantitative and qualitative techniques do you use for GSEs that have different lines of business, that operate in different sectors of the economy, and that have different organizational structures?

For Moody's assessment of the various risks of each GSE, please refer to the individual credit reports on the Federal Home Loan Banks, Freddie Mac, Fannie Mae, Sallie Mae and the Federal Farm Credit Banks.

For a discussion of the quantitative and qualitative techniques Moody's uses to analyze GSEs, please see Moody's special comment on GSEs.

Question #3 If Moody's has already rated the GSEs absent their ties to the government, what are the ratings?

Moody's has not yet rated the GSEs absent their ties to the U.S. Government, although we plan to do so by the end of the summer.

Question #4 How significant are the differences between various investment-grade ratings? How significant is the difference between investment-grade ratings and non-investment-grade ratings? Are these differences quantitative or qualitative?

For an analysis of the default characteristics associated with different rating categories, please refer to Moody's Default Study.

Question #5 Does Moody's have criteria that firms must satisfy in order to obtain particular ratings, e.g. triple-A? Could you give criteria for different ratings that the government could use in creating business plans for GSEs?

"Criteria" implies that the rating process is formula-driven, which is not the case. The standards that are used to determine ratings are varied and are ultimately subjective, and reflect the opinions of a rating committee of experienced professionals about the likelihood of default. Quantifying these standards is not practically possible.

STATEMENT OF THE
NATIONAL ASSOCIATION OF REALTORS®
SUBMITTED TO
THE SENATE HOUSING SUBCOMMITTEE ROUNDTABLE
ON THE
SAFETY AND SOUNDNESS OF FANNIE MAE AND FREDDIE MAC

AUGUST 2, 1990

INTRODUCTION

The 800,000 members of the NATIONAL ASSOCIATION OF REALTORS® are pleased to have the opportunity to present this association's views regarding the safety and soundness of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), and proposals to alter their regulatory structure and budgetary treatment.

Our statement focuses on: (1) the role of Fannie Mae and Freddie Mac in the development and operation of the secondary mortgage market; (2) their impact in housing; (3) proposals to alter the regulatory treatment of Fannie and Freddie and resulting impact on housing; and (4) recommendations.

OVERVIEW

The NATIONAL ASSOCIATION OF REALTORS® appreciates why U.S. government-sponsored enterprises (GSEs), particularly the housing-oriented GSEs, have gained prominence in the eyes of Congress and further, why they have now emerged as a major public policy issue. Indeed, the greater prominence reflects several factors including the rapid integration of technology with mortgage finance instruments, increasing number of GSEs active in the global debt markets, the proportion of U.S. credit in the United States represented by the offerings of GSEs, and recent problems experienced by some GSEs.

Clearly, the two greatest factors driving scrutiny of the federally chartered corporations today, however, are the potential financial contingent liability to the U.S. Government created by the nearly $800 billion in GSE obligations and the safety and soundness concerns prompted by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA).

The aftermath of the thrift industry debacle has focused the nation's lawmakers, housing finance industry and housing advocates on the issue of capital adequacy of our lending institutions. The NATIONAL ASSOCIATION OF REALTORS® shares this concern; our industry is dependent upon a consistent supply of affordable mortgage credit. Nevertheless, we caution against viewing every financial question as an imminent debacle.

The NAR recognizes and supports the need to establish and maintain effective mechanisms for monitoring and managing the activities of GSEs. This is the appropriate role and, indeed, the responsibility of Congress. We commend this Committee for asserting its jurisdiction over the housing related GSEs. We firmly believe that Fannie Mae and Freddie Mac are and should be subject to federal oversight and regulation. We would note, however, that congressional proposals to alter oversight and regulatory authorities must recognize the unique character and structure of these entities to preserve their ability to operate in a safe and sound manner while, at the same time, meet their federally charged public policy role.

We believe that the Treasury Department/Office of Management and Budget (OMB) proposals to alter oversight and regulatory authorities are inappropriate. The responsibility for regulating these GSEs is exclusively and properly that of the federal government, and can be delegated only to an agency such as HUD, rather than directly or indirectly to a private organization such a rating agency, as proposed by Treasury.

We believe the possibility of either of the secondary mortgage market GSEs (i.e., Fannie Mae and Freddie Mac) failing in the future is remote. In fact, both government and private sector audits confirm their financial strength. We certainly agree, however, that the U.S. Government has legitimate concerns regarding identification and control of the risk associated with their activities. We commend the Congress for taking the initiative in mandating studies of GSEs in the Financial Institutions Reform, Recovery and Enforcement Act of 1989. These studies have provided valuable information and have laid a solid foundation for a thoughtful and deliberate consideration of this issue. We would caution at the outset, however, that this issue should be driven by reason, rather than by hasty and ill-conceived actions which may have farreaching deleterious consequences.

ROLE AND IMPACT OF THE SECONDARY MORTGAGE MARKET GSEs ON THE HOUSING FINANCE DELIVERY SYSTEM

Fannie Mae and Freddie Mac are privately owned, government-chartered corporations whose mandate is to bring liquidity to the secondary mortgage market to ensure the availability of affordable housing finance.

Our mortgage finance delivery system has evolved significantly during the 1980s, a process that has allowed the system to seal itself off from the problems in what was until recently, its major source of funds -- the savings and loan industry. Indeed, driving forces including dramatic changes in technology, mortgage instruments and risk management have elevated the role and importance of Fannie Mae and Freddie Mac as the primary conduit of mortgage credit and concomitantly, diminished the role of the thrift industry in providing mortgage capital.

Fannie Mae and Freddie Mac fill central roles in the secondary mortgage market. These two agencies and Ginnie Mae, which securitizes the mortgages insured by the Federal Housing Administration (FHA) and guaranteed by the Department of Veterans Affairs (DVA), are crucial in the home mortgage delivery system. They successfully integrate mortgage markets -- home buyers -- with the capital market. Based on the activities of these GSEs, the secondary market has grown substantially from its infancy in the late 1970s and early 1980s. Between 1980 and 1989, the annual volume of mortgages repackaged as securities and sold in the secondary market increased from $22 billion to $195 billion. By the end of 1989, there were $750 billion in mortgage-backed securities outstanding, $360 billion of which were Ginnie Maes.

Fannie Mae and Freddie Mac dominate the conventional mortgage market. HUD estimates that over 78 percent of the total volume of mortgage loans is conforming conventional mortgages. Fannie Mae and Freddie Mac's market share of that proportion is estimated at nearly 86.3 percent. Together they have financed homes for over 17 million American families.

The growth of the secondary mortgage market has profoundly affected the availability of mortgage credit to home buyers. Effectively mortgage interest rates are no longer subject to the vagaries of thrift institutions deposit flows. The gross inefficiencies of home financing of the 1960s and 1970s are largely corrected, with the secondary mortgage market providing liquidity that has opened up consistent sources of affordable funds for home buyers.

During the 1980s much was made of the potential for the private sector's capacity to perform the secondary mortgage market role that Fannie Mae and Freddie Mac performed. Yet there has been limited development of private sector secondary mortgage entities. By year-end 1989, private MBSs constituted less than 5 percent of those outstanding. Clearly, these GSEs have been essential in a market that the private sector has been unable or unwilling to serve.

Equally important is Fannie Mae and Freddie Mac's contribution to market efficiency. They have brought standardization and homogeneity to mortgage products. They have created an efficient, smoothly functioning and highly disciplined market, the hallmark of our mortgage finance system.

GOVERNMENT-SPONSORED-ENTERPRISE STRUCTURE IS UNIQUE

FIRREA reaffirmed the importance of missions for Fannie Mae and Freddie Mac, by restating their mission to:

(1) provide stability in the secondary market for home mortgages;

(2) respond appropriately to the private capital market; and

(3) provide ongoing assistance to the secondary market for home mortgages (including mortgages securing housing for low- and

> moderate-income families involving a reasonable economic return) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for home mortgage financing.

Fannie Mae and Freddie Mac are charged with maintaining a continuous presence in the secondary market, regardless of economic conditions, and with developing mortgage products and services to meet the needs of home buyers and the objectives of federal housing policy. These GSEs are also charged with the continuing development of mortgage products and services and financing methods that improve the efficiency of the secondary markets to distribute capital for mortgages.

The GSE structure is unique. It marries the public purpose of a federal agency to the business capabilities of the private sector corporation. Congress deemed this structure an appropriate mechanism to accomplish social purposes -- in this instance develop and maintain a secondary mortgage market that has served to provide stability through the current aftermath of the thrift debacle. Significantly, although there is arguably a credit crunch for commercial real estate and small business in some regions, there is still no lack of mortgage credit available for home buyers.

IMPACT OF THE TREASURY AND OMB PROPOSALS ON THE HOUSING DELIVERY SYSTEM

The Treasury Department proposes that the GSEs obtain a triple-A rating from two nationally recognized, Treasury-approved credit rating agencies, in a process that disregards any implicit or explicit federal guarantee or other benefits. Failure to acquire this rating would require developing a business plan, acceptable to Treasury, to reach the rating within five years. The plan would contemplate limits on dividends, growth, debt issuance, salaries and benefits, reductions in financial leverage, or other limitations to achieve the triple-A rating.

The OMB adopts the Treasury proposal and proposes "enforcement" alternatives that include possible volume limitations and growth caps on GSEs, the exact level to be determined by the rating agencies.

The NATIONAL ASSOCIATION OF REALTORS® strongly opposes this proposal.

ABDICATION OF FEDERAL GOVERNMENT POLICY RESPONSIBILITY

Unquestionably, it is the role and responsibility of the Federal government to oversee and regulate GSEs. This responsibility cannot be delegated to the private sector. The Treasury proposes to take just this step. The NAR believes such actions would constitute an unprecedented abdication of government responsibility and priority to set policy. A private rating company, not subject to government supervision, would determine the creditworthiness, and thus the business activities, of enterprises created for the public interest. This is delegation of the federal government's control and program responsibilities for GSEs to entities outside the public domain.

It is not hard to imagine a scenario, for example, that may set the Community Reinvestment Act (CRA) requirements of lenders at odds with the roles that Fannie Mae and Freddie Mac play in providing mortgage credit for lenders to make central city mortgage loans. Will the private rating agencies downgrade Fannie Mae's or Freddie Mac's credit rating if their lending exceeds a certain level in a particular city? Could this practice not be mortgage credit allocation in a new guise?

Further, the Treasury proposal requires that the GSEs achieve a triple-A rating without regard to their federal status. We believe this is inappropriate and unduly restrictive. It ignores their federally chartered mandate to maintain a single line of business (with no opportunity for diversification) in order to achieve a rating standard the requirements for which are not concrete, identifiable or published. We are aware of few private financial entities which have achieved such a rating and can see no evidence in any of the government's own studies that suggest its necessity. On the contrary, we believe such a requirement would substantially impede their ability to function and unnecessarily and disastrously disrupt the mortgage market.

There is the potential for additional paradox in the Treasury required triple-A rating. FIRREA mandated that Fannie Mae and Freddie Mac provide ongoing assistance to the secondary market for home mortgages. The Act includes mortgages securing low- and moderate-income families involving a reasonable return. Clearly these mortgage are likely to have more risk associated with them. The Treasury proposal could require the rate-driven and possible growth-constrained secondary mortgage market GSEs to become risk-adverse, clearly at odds with their statutory mandate.

THE PROPOSAL DISCOUNTS THE NATURE AND ROLE OF GSEs

The Treasury proposal severely compromises the public policy reasons for which Fannie Mae and Freddie Mac exist. Moreover, it would sacrifice the ability of these entities to meet their public policy objectives solely on the basis of an admittedly remote possibility (acknowledged by Treasury) that either entity could require federal intervention.

The cost of this overzealous and onerous proposal is high. It would raise the cost of mortgage credit; remove the countercyclical stabilization of mortgage markets, making them more volatile; induce a credit crunch for mortgage capital; impair the value of depository institutions; and exacerbate the thrift crisis.

Federal housing policy objectives presume that GSEs should take some risks that other corporations cannot in pursuit of policy objectives. It is Congress' responsibility to ensure that the risks undertaken by GSEs are prudent and appropriate. The Treasury/OMB proposal, however, would upset this delicate balance and would sacrifice federal housing policy considerations for what could be viewed as an ideological hostility to GSEs in housing.

The proposal also discounts the principal activities that the GSEs take to ensure against the essential business risks they necessarily protect against -- interest rate risk and credit risk. Each GSE has developed strategies that are designed to protect against excessive exposure to either kind of risk, and to build an adequate capital base.

Credit risk is the prospect that a loan will default. Fannie Mae and Freddie Mac have established strategies to permit management of the credit risk presented by the mortgages they finance. Both corporations use underwriting, quality control and servicing criteria that ensure that borrowers will repay their mortgages, and that the collateral is adequate in the event of default. Both require mortgage insurance on loans with downpayments of less than 20 percent. Both monitor the quality and performance of their seller/servicers, and both use credit enhancements, including collateral and recourse requirements, to insulate them from risk of loss.

Interest rate risk is the risk of loss due to changes in interest rates that negatively affect a firm's assets value. Fannie Mae and Freddie Mac have different sensitivities to interest rate risk, due to their different financing strategies. Both organizations use mortgage-backed securities as a cornerstone of their business activities. The nature of the security actually shifts interest rate risk to the security investor.

Fannie Mae also uses portfolio analysis and asset/liability management techniques to insulate its earning from changes in interest rates.

In contemplating the contingent liability that the housing GSEs pose to the federal government, it is too easy to view and to treat these corporations as thrifts or perhaps mortgage insurers. The Treasury report on government-sponsored enterprises spoke to these possible comparisons, concluding that the capitalization of both corporations should not be based on the risk-based rules that apply to banks and thrifts. The Treasury report also concluded that the frequent comparison of the housing GSEs to private mortgage insurers is also inappropriate, because "a substantial number of significant differences" between the two exist.

Clearly, Fannie Mae and Freddie Mac are not lenders in the traditional sense. They do not gather deposits, and they are not primary lenders. They have portfolios with national diversification, almost unrestricted access to capital markets, substantial fee income from the guarantees they place on their securities, and a federally-mandated asset concentration in residential mortgages. We concur with the Treasury's conclusion that these characteristics make inapplicable the risk based capital requirements established for financial institutions.

The Treasury report also concluded that these GSEs are not comparable to private mortgage insurers. The principal difference lies in the position each takes with respect to loan default. Private mortgage insurers are the primary risk carriers, standing in front of the GSEs to absorb losses on the insured portion of the loan, while the GSE is secondarily liable.

THE PROPOSALS DESTROY THE COUNTERCYCLICAL UTILITY OF FANNIE MAE AND FREDDIE MAC

In the stagflation of the 1970s and the recession of the early 1980s, Fannie Mae and Freddie Mac served housing markets when private companies withdrew. Most recently the two GSEs stayed in the Oil Patch when private firms withdrew from that market. In fairness to the private sector, these private companies had to withdraw or risk significant financial loss, but Fannie Mae and Freddie Mac were created, in part, to provide a mechanism for home mortgage funds to be available in hard economic times. The Treasury proposal's tying growth to a rating based on a GSE's financial risk profile at a particular time, means that Fannie Mae and Freddie Mac would be penalized for doing what they were created to do.

THE PROPOSAL WOULD CREATE DISRUPTION IN THE HOUSING MARKET

NAR believes that the Congress and Administration have chosen an inopportune time to consider reducing the role of Fannie Mae and Freddie Mac. Real estate lending nationwide has contracted for two reasons. First, FIRREA imposed severe growth and lending restrictions on thrift institutions. Second, federal banking regulators, appropriately concerned that the banking industry not experience a debacle similar to what the savings and loan industry underwent, have undertaken stricter oversight of depository institution lending activity. The zealous regulatory effort to assure appropriate supervision and examination, when combined with overbuilding, a slowing economy and commercial real estate loans turning sour have cause many lenders to overreact. The result has been a severe contraction in the availability of credit in many areas, particularly in the commercial real estate market. The presence of Fannie Mae and Freddie Mac in the mortgage market, however, has been a principal factor ensuring the successful consummation of residential real estate transactions.

The housing market is buoyed by the presence of Fannie Mae and Freddie Mac. More than 86 percent of the 1989 fourth quarter dollar amount of the conforming conventional mortgages originated were financed by Fannie Mae and Freddie Mac. The Treasury proposal could well send another significant shock wave through housing finance markets, shaking the confidence of investors and lenders that the secondary market GSEs can continue to serve as an outlet for home mortgage loans. There is no credit crunch for home mortgage funds, but this proposal could create one.

RECOMMENDATIONS AND CONCLUSION

Federal oversight of GSE activity is appropriate and necessary. We believe that the Treasury/OMB proposal is an overreaching and potentially disastrous vehicle. Through the provisions of FIRREA, Congress has established a sound and workable mechanism to carry out its oversight function by delegating to HUD the regulation of Fannie Mae and Freddie Mac. HUD has already established a division within the department that is charged with carrying out its responsibilities as mandated under FIRREA, undertaken extensive studies of each of the two GSEs, and held public hearings on the nature and scope of the regulatory framework they are establishing. The NATIONAL ASSOCIATION OF REALTORS® strongly believes that the nation's federal housing agency is the appropriate entity to discharge the responsibilities of federal oversight for the secondary mortgage market GSEs.

The NATIONAL ASSOCIATION OF REALTORS® strongly supports the activities and public policy mission of Fannie Mae and Freddie Mac. Their role is crucial and necessary in the home mortgage finance system. Their prudent operation and their success in meeting their public policy goals reaffirms that the role and structure Congress has mandated is proper.

We also support federal oversight and regulation of these GSEs to assure their continued operation in a safe and sound manner. The NATIONAL ASSOCIATION OF REALTORS® believes that fiscal ideology should not drive federal housing policy without the development of a real consensus on this issue. The Treasury/OMB proposal is narrowly focused and does not frame the housing policy debate appropriately. We believe that Congress should not remake housing policy or recast the role of the housing GSEs in a budget forum. The proper forums for this debate are the Senate Housing Subcommittee and its counterpart in the House of Representatives.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM

ALFRED DELLIBOVI

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
THE UNDER SECRETARY
WASHINGTON, D.C. 20410

September 18, 1990

**Honorable Donald W. Riegle, Jr.
Chairman, Committee on Banking,
Housing, and Urban Affairs
United States Senate
Washington, DC 20510**

Dear Mr. Chairman:

As you requested in your letter of August 14, 1990, I have enclosed the answer to Senator Christopher Dodd's question regarding Fannie Mae and Freddie Mac.

If I can be of further assistance, please do not hesitate to contact me.

Very sincerely yours,

Alfred A. Delli Bovi

Alfred A. DelliBovi

Enclosure

Q.1. Overall, your report indicates that Fannie Mae and Freddie Mac are strong and getting stronger. Do you see any reason for overhaul of the GSEs to be carried out in the context of the budget summit -- before the obvious complexities of these issues are explored and considered?

A.1. FIRREA anticipated a two year timeframe for deciding on the next steps. Both GAO and Treasury were required to do studies of the risk and capital adequacy of the GSEs. They have completed interim reports, and their final reports due in May 1991 will focus more extensively on recommendations for capital adequacy requirements. In addition, HUD's annual reports on FNMA and FHLMC laid out detailed analyses on safety and soundness issues which we plan to do over the next year. These analyses by Treasury, GAO and HUD should provide a firm basis for setting capital standards for FNMA and FHLMC. However, we have no objections if Congress and the budget summit want to act more quickly.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM

THOMAS GILLIS

Q 1. How much weight would you give to the GSE's public missions in determining the rating?

A 1. When analyzing the risk to the federal government, Standard & Poor's looks at the business being carried out by that GSE. The public mission is not considered specifically in this analysis. However, authorizing legislation can have an impact on the risk. For example, the GSE's can only operate in the areas authorized by the Congress. The cannot diversify business lines to balance the risk of one type of service.

Q 2. Among other things, Fannie Mae's and Freddie Mac's public mission requires that they serve low- and moderate-income housing and that they also serve as a countercyclical force in markets experiencing an economic downturn. Would these activities have an impact on the ratings Fannie Mae and Freddie Mac achieve?

A 2. Purchasing mortgages in a countercyclical environment and purchasing for low-and moderate income housing do not necessarily mean lower credit quality nor greater financial risk for Fannie Mae and Freddie Mac. The main component to review to determine risk for the areas you have mentioned would be the underwriting guidelines. Overall asset quality is primarily a function of underwriting guidelines - strong and consistent underwriting for both single family and multi-family loans/mortgages lead to good asset quality. Results of underwriting practice are reflected in operating results in the form of delinquencies and foreclosures. Fannie Mae and Freddie Mac today purchase loans which provide housing for low- and moderate-income families and Standard & Poor's feels that both entities overall are at least investment grade in credit quality.

FannieMae

Fannie Mae's Low- and Moderate-income Housing Initiatives

Chairman's Message

This report describes Fannie Mae's initiatives designed to help finance housing for low- and moderate-income renters and home buyers. These activities supplement the substantial role Fannie Mae's standard programs play in providing financing for those of modest means.

Administered by our Office of Low- and Moderate-Income Housing, these initiatives reflect Fannie Mae's strong commitment to addressing the full spectrum of housing needs.

As the USA's Housing Partner, Fannie Mae is proud of what we have accomplished already, and we seek to do more. We invite public agencies, nonprofit organizations, lending institutions, and other private corporations to join us in developing creative partnerships to benefit those most in need of housing aid.

David O. Maxwell

David O. Maxwell
Chairman and Chief Executive Officer

Fannie Mae's Role in Mortgage Finance

Fannie Mae (the Federal National Mortgage Association) is a shareholder-owned corporation with a federal charter. Our mission is to act as the nation's housing partner--providing a wide variety of products and services that increase the availability and affordability of housing for low-, moderate-, and middle-income Americans. Our federal charter limits our purpose to helping increase the flow of funds to finance home mortgages--both single-family and multifamily. We finance about one out of every seven mortgages originated in the United States.

Fannie Mae provides funds for residential mortgages principally in two ways. First, we purchase mortgage loans for our portfolio. We finance those purchases by selling debt securities to investors. Second, Fannie Mae issues and guarantees Mortgage-Backed Securities (MBS) that are backed by loans originated by mortgage lenders. Together, these two mechanisms increase the pool of potential investors in home loans and allow us to offer the widest possible range of mortgage products.

Fannie Mae acquires home mortgages from a network of 3,000 primary mortgage lenders in all regions of the country. Approximately 47 percent of our business is with thrift institutions and commercial banks; 46 percent is with mortgage bankers; the remainder of our business is with others in the marketplace, including state and local housing finance agencies.

Operating under limits established in our federal charter, Fannie Mae serves a broad array of America's low-, moderate-, and middle-income families. During 1989, using our traditional mortgage products, Fannie Mae assisted one million home buyers and homeowners by purchasing loans or packaging them into securities. The average-sized loan we bought or packaged into securities in 1989 was $83,000. Nearly one of every five loans we bought or securitized was under $40,000.

Because Fannie Mae is limited by law to the business of residential finance, we provide an assured source of support for mortgage lending that is available in all areas of the country and during all economic circumstances.

Fannie Mae is headquartered in Washington, DC. We operate regional offices in Atlanta, Chicago, Dallas, Pasadena, and Philadelphia.

Table of Contents

Introduction

Fannie Mae's Role in Mortgage Finance 3

Low- and Moderate-Income Housing Initiatives 5

Public Finance Activities

Guidelines 13

Purchase of Tax-Exempt Mortgage Revenue Bonds 17

Single-Family Tax-Exempt Credit Enhancement 19

Access to the Secondary Mortgage Market for Non-Standard Loans 21

Credit Enhancement for Multifamily Developments 23

Credit Enhancement for Bond Refundings 27

Community Lending Activities

Single-Family Community Lending Guidelines 31

Atlanta Mortgage Consortium 39

Baltimore Acquisition and Rehabilitation Program 41

Burton Neighborhood Housing Services Lease-Purchase Initiative 43

Cleveland Lease-Purchase Program 45

Columbus Housing Partnership Affordable Rental and Lease-Purchase Initiative 47

Community Assisted Shared Appreciation (CASA) Homeownership Loan Program 49

Community Home Buyer's Program 51

Community Preservation Corporation's Homeownership Program 57

Dallas Housing Authority Lease-to-Own Program 59

Dallas Housing Partnership 61

Detroit Homeownership Initiatives 63

Homes for South Florida 65

HomeSight 67

Massachusetts Bankers Association First-Time Home Buyer Initiative 71

Master Community Lending Agreements 75

Mortgage Credit Certificates 79

National Training and Information Center Home Lending Program 81

New York City and State/Dime Programs 85

New York City Employees' Retirement System Homeownership Program 87

New York City Housing Partnership New Homes Program with Norstar Mortgage Company 89

New York State Affordable Mortgage Program/Goldome 91

Philadelphia Neighborhood Enterprise Moderate Rehabilitation Program 93

Redding Down Payment Assistance Program 95

Rhode Island Housing and Mortgage Finance Corporation Lease-Purchase Initiative 97

San Jose First-Time Home Buyer Program 99

Santa Ana Mortgage Assistance Program 101

South Shore Bank of Chicago Homeownership Initiative 103

Tampa Bay Community Development Homeownership Opportunity Program 105

Townview Terrace 107

Triangle Housing Partnership 109

Walk Home Program 113

Walker's Point 115

Wilmington Block Stabilization Program 117

Multifamily Community Lending Guidelines 121

Purchase of Loans Under Prior Approval and Delegated Underwriting and Servicing Programs 125

Apartment Improvement Program (AIP)/ Neighborhood Housing Services (NHS) 129

Low Income Housing Fund 131

Low-Income Rental Housing Equity Investments

Guidelines 135

Ashburton Apartments 139

Bickerdike 141

Douglass Park 143

East Star Properties 145

Empire State 147

Fifty Washington Square 149

Georgia Housing Restoration 151

Highland Park Apartments 153

Home Suites Apartments 155

Longwood Apartments 157

Lowell North Canal and 442-462 Merrimack Street 159

Massachusetts Housing Initiatives 161

Mercy Family Plaza 163

Mixed-Use Housing Developments 165

Montgomery County Housing Opportunities Commission 167

Mount Baker 169

National Temple 171

New York City Low-Income Rental Housing Rehabilitation Initiative 173

Northgate Apartments 177

Riverside Plaza 179

Rotary Haciendas Senior Apartments 181

Rural Rental Housing 183

Shalom House 185

Southern Hills 187

State and Local Housing Equity Funds 189

Wood Street Commons 191

Other Housing Affordability Initiatives

Capital Opportunities for Community Development 195

Employer-Assisted Housing Demonstration 197

Energy-Efficient Mortgages/Energy Rated Homes 199

Home Ownership Protective Effort (HOPE) 201

Mortgage Bankers Association Affordable Housing Initiative 203

National Association of Home Builders Affordable Housing Initiative 205

National Association of Housing and Redevelopment Officials REO Initiative 207

National Association of Neighborhoods/ National Housing Sponsors Program 209

Sale of Multifamily Real Estate Owned For Low- and Moderate-Income Use 211

The Fannie Mae Foundation 215

Fannie Mae Regional Offices 219

Home Office Contacts 223

Index of Initiatives by State 227

Low- and Moderate-Income Housing Initiatives

Working with lending institutions, states, localities, nonprofit organizations, and other corporations, Fannie Mae has developed and implemented a number of initiatives targeted to low- and moderate-income home buyers and renters.

As described in the preceding section, much of Fannie Mae's business activity directly benefits households of modest means. To increase its efforts on behalf of such households, in 1987 Fannie Mae created an Office of Low- and Moderate-Income Housing. This office is responsible for managing Fannie Mae's current initiatives and for creating additional ones to expand housing opportunities for lower income families and individuals. Since the Office of Low- and Moderate-Income Housing was created, Fannie Mae has committed to provide more than $3.5 billion in specialized financings throughout the country to assist more than 70,000 households.

Initiatives Targeted to Low- and Moderate-Income Households

I. Public Finance Initiatives

Fannie Mae offers a variety of financial products for state and local housing finance agencies designed to lower the agencies' borrowing costs and, thus, to enhance housing affordability for low- and moderate-income people.

In 1987 Fannie Mae launched an initiative to purchase tax-exempt mortgage revenue bonds issued by housing finance agencies. By purchasing these bonds through negotiated private placements, Fannie Mae enables the agencies to reduce their costs of issuance. These savings make it possible for the agencies to offer mortgages at lower rates than otherwise would be possible. During the past three years, Fannie Mae has purchased approximately $2.2 billion of mortgage revenue bonds, helping to provide affordable financing for an estimated 37,000 low- and moderate-income families--the great majority of them first-time home buyers.

Fannie Mae can also provide credit enhancement for tax-exempt bonds issued by housing finance agencies to finance homeownership or the development of rental housing units. Fannie Mae can either issue mortgage-backed securities or pledge mortgage collateral from our portfolio to assure the timely payment of principal and interest on state and local housing bonds. In both ways, Fannie Mae helps reduce the agencies' borrowing costs. Financial institutions participating in these activities can therefore originate mortgages at lower rates.

Recently, Fannie Mae entered into an agreement with the Vermont Housing Finance Agency to provide credit enhancement for $100 million of nonstandard single-family mortgages held by lenders doing business in Vermont. Our arrangement with the Housing Finance Agency permits the lenders to generate new capital from loans that could not otherwise be easily sold in the secondary market. Under the terms of this initiative, participating lenders will reinvest at least 50 percent of the proceeds from the sale of the loans in debt or equity instruments to support additional affordable housing.

II. Community Lending Initiatives

Fannie Mae offers specially-designed loan-purchase initiatives intended to help finance either the purchase of homes by low- and moderate-income households, or the development of rental housing affordable to these families.

In its single-family community lending initiatives, Fannie Mae works with lenders, mortgage insurers, public agencies, and nonprofit organizations within communities to design housing partnerships for lower income home buyers who otherwise would be priced out of the market. These products help lenders who have community reinvestment goals and borrowers who have few, if any, other means of homeownership.

Generally, the affordability models include a 5 percent cash down payment by the borrower and the purchase of a market-rate first mortgage by Fannie Mae. To enhance affordability, Fannie Mae allows unsecured financing of closing costs and subsidized second mortgages for community lending loans. The second mortgages are provided by a state or local government, or by a nonprofit organization. Nonprofit groups often play a role in housing development, in providing prepurchase counseling, and in helping to identify potential home buyers.

Fannie Mae is successfully working with mortgage insurers on affordable single-family community lending initiatives in numerous cities nationwide. Under these initiatives, lenders will provide 95 percent loan-to-value ratio loans that will be insured by the mortgage insurers and purchased by Fannie Mae.

Fannie Mae also participates in short-term lease-purchase programs where nonprofit organizations or public agencies purchase and rehabilitate properties that are occupied by tenant/purchasers. During the lease term--typically three to five years--the nonprofit or public agency owner works with the tenant/purchaser so that the family is capable of assuming the mortgage at the end of the lease. Fannie Mae purchases the first mortgage when rehabilitation is complete.

As of February 1990, Fannie Mae had made commitments to purchase approximately $900 million in mortgages that will serve some 15,000 home buyers.

In addition, on a case-by-case basis, Fannie Mae purchases multifamily loans on rental housing projects that serve lower income tenants. As with our single-family community lending initiatives, our multifamily community lending efforts often involve public subsidies. Nonprofit organizations may participate as project developers. The purchase of loans financing low- and moderate-income rental housing can be arranged under either our Prior Approval or Delegated Underwriting and Servicing programs--or through community lending agreements that may involve public agencies and nonprofit organizations as well.

III. Low-Income Rental Housing Equity Investments

Since 1986, when the Congress authorized a program of tax credits for investments in qualified low-income rental housing projects, Fannie Mae has undertaken selected investments in such projects to help promote the development of affordable rental housing.

Through February 1990, Fannie Mae had made commitments to invest more than $150 million in qualifying projects. These projects--located in numerous communities throughout the country--will help finance the development of more than 8,000 badly needed units of affordable rental housing. The projects in which Fannie Mae has invested will provide housing for families, for the elderly, and for formerly homeless people. A large share of Fannie Mae's commitments are directed toward areas that pose special development challenges. They often involve the participation of nonprofit community groups.

Fannie Mae is especially interested in helping to finance projects identified by states and localities as serving particularly pressing housing needs. In addition, Fannie Mae is making an effort to encourage other corporations to join us in tax credit investments.

IV. Other Affordability Initiatives

Fannie Mae supports a number of other initiatives designed to increase the access of lower income people to decent, affordable housing. Examples include:

- An initiative with the National Community Development Association and CD Financial to explore developing a secondary market for residential mortgages that are written and currently held by local governments.
- A demonstration project to create models for the development of employer-assisted housing in high-cost markets where workers find it difficult to afford housing near their places of employment.
- A joint initiative with the National Association of Housing and Redevelopment Officials (NAHRO) to assist low- and moderate-income households to own their own homes or rent affordable housing. This is accomplished through the sale of properties owned by Fannie Mae to a network of NAHRO local agency members, including public housing authorities, community development agencies, and nonprofit organizations.
- An arrangement with the Mortgage Bankers Association of America to provide up to $100 million in financing for rental housing projects serving low- and moderate-income families in five communities.
- A joint initiative with the National Association of Home Builders to combine innovative design and local regulatory relief with flexible financing to reduce the costs of homeownership for low- and moderate-income families.

The Office of Low- and Moderate-Income Housing is also responsible for managing and developing policy regarding Fannie Mae's portfolio of multifamily project mortgages insured by the Federal Housing Administration. As of February 1990, Fannie Mae owned as whole loans, or serviced in securities, more than 3,400 FHA-insured project mortgages with an unpaid principal balance of $4.6 billion. The majority of these mortgages were written in the 1960s and 1970s and are insured under the Section 236, Section 221(d)(3), and Section 221(d)(4) programs.

Where to get more information

Staff of Fannie Mae's Office of Low- and Moderate-Income Housing--and in our five regional offices--are available to work with mortgage lenders, state and local housing agencies, nonprofit organizations, and other private corporations to help develop effective programs designed to meet local housing needs in communities throughout the country.

For additional information concerning Fannie Mae's Office of Low- and Moderate-Income Housing, contact:

Martin D. Levine
Vice President for Low- and Moderate-Income Housing
Fannie Mae
3900 Wisconsin Avenue, NW
Washington, DC 20016-2899
(202) 752-6030

How to use this publication

The remainder of this publication describes Fannie Mae's low- and moderate-income housing initiatives in more detail. The descriptions indicate where each initiative is operating; how it works; what Fannie Mae's role is; who the other participants are; and where one can get additional information.

An additional section describes the work of the Fannie Mae Foundation, which also supports housing affordability efforts, among other goals. The publication concludes with lists of contacts in Fannie Mae's regional offices and in the Washington, DC Office of Low- and Moderate-Income Housing. An index lists our low- and moderate-income housing initiatives by state.

MORTGAGE BANKERS
ASSOCIATION OF AMERICA

Michael J. Ferrell
Senior Staff Vice President
& Legislative Counsel

Tel. (202) 861-6509
Fax (202) 452-8785

August 16, 1990

The Honorable Alan Cranston
Chairman
Subcommittee on Housing and Urban Affairs
Committee on Banking, Housing and Urban Affairs
U.S. Senate
Washington, D.C. 20510

Dear Mr. Chairman:

The Mortgage Bankers Association of America respectfully requests that the attached statement regarding the Federal Home Loan Mortgage Corporation (FHLMC) and the Federal National Mortgage Association (FNMA) be included in the Subcommittee's hearing record of August 2, 1990. We have commented on the critical role of FHLMC and FNMA in ensuring the availability of mortgage credit. We have also outlined our concerns regarding the recent proposals put forth by the Treasury Department to impose more stringent capital requirements for Government Sponsored Enterprises (GSEs), particularly FHLMC and FNMA.

MBA feels that Congress should examine GSEs carefully. We do, however, feel that Treasury proposals requiring FHLMC and FNMA to obtain triple-A ratings from private credit rating agencies, absent any implicit government guarantees, establish artificial and unachievable goals. MBA urges a more measured response. The imposition of safety and soundness goals without factoring in the mission of FNMA and FHLMC will have a significant impact on both mortgage credit affordability and availability. If FHLMC and FNMA were required to raise an arbitrary amount of capital to help protect the government against extremely remote economic circumstances, this would raise their costs and result in higher interest rates for homebuyers.

We appreciate the Subcommittee's continued efforts to examine this important issue and we will be happy to provide any additional information that may be needed.

Sincerely,

Michael J. Ferrell

Michael J. Ferrell

MJF:JS:lm
Attachment

1125 Fifteenth Street, N.W.
Washington, D.C. 20005-2766

1125 Fifteenth Street, N.W.
Washington, D.C. 20005

Mortgage Bankers Association of America

FAX: (202) 452-8785
PHONE: (202) 861-6505

STATEMENT
of the
MORTGAGE BANKERS ASSOCIATION OF AMERICA
for the
SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT
of the
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

Hearings on

Federal Home Loan Mortgage Corporation
Federal National Mortgage Association

August 2, 1990

The Mortgage Bankers Association appreciates this opportunity to submit a written statement with respect to the role of the Federal government in stabilizing the mortgage credit markets and ensuring a supply of affordable mortgage credit through the programs and operations of the Federal Home Loan Mortgage Corporation (FHLMC), and Federal National Mortgage Association (FNMA).

The Treasury proposals that are being circulated at this time, in our opinion, establish artificial and unachievable goals--they are simply a backdoor mechanism to curtail or even shut down the mortgage credit market support that has been created by Congress. We have seen a decade's worth of privatization proposals for both FHLMC and FNMA. Each time the wolf has been dressed in a different sheep's skin.

Yet in the context of the thrift crisis, the wolf's cry has taken on a pitch that is increasingly strident.

We urge a more measured response. The imposition of safety and soundness goals without factoring in the mission of FNMA and FHLMC will have a significant impact on both mortgage credit *affordability* and *availability*.

Nor is there any immediacy in the situation that mandates a response. We are not insinuating that Congress must wait for a crisis to develop in order to react, but we are urging a reasoned response that will preserve Congressional jurisdiction over these programs, rather than a purely market-driven discipline that will be blind to the important mission that they serve.

MBA supports Federal sponsorship of a mortgage credit delivery system. We believe this support should be provided through secondary mortgage market programs and operations that are self-sustaining and actuarially sound. By all accounts the mortgage-backed securities operations of FHLMC and FNMA cover their administrative expenses and have established reserves. Their operations are subject to varying degrees of regulatory oversight and control. Their missions, finally, are specifically circumscribed in their Congressionally mandated charters.

Approximately 51 percent of the loans originated by mortgage bankers are purchased or securitized by FNMA and FHLMC. Additionally, the mortgage banking industry originates approximately 75 percent of all FHA loans. Virtually all of these loans are packaged into securities and guaranteed by GNMA under its Mortgage Backed Security (MBS). Consequently, MBA has a sound knowledge of the secondary mortgage market and the factors that have been largely responsible for the success of the secondary market entities over the years.

---

* The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of residential and commercial real estate finance. MBA's membership comprises mortgage originators and servicers, as well as investors, and a wide variety of mortgage industry-related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, selling, and servicing real estate investment portfolios. Members of MBA include:

- Mortgage Banking Companies
- Commercial Banks
- Mutual Savings Banks
- Savings and Loan Associations
- Mortgage Insurance Companies
- Life Insurance Companies
- Mortgage Brokers
- Title Companies
- State Housing Agencies
- Investment Bankers
- Real Estate Investment Trusts

MBA headquarters is located at 1125 15th Street, N.W., Washington, D.C. 20005,
Telephone: (202) 861-6500.

BACKGROUND

FNMA and FHLMC are privately owned corporations with Congressional mandates to support homeownership through self-sustaining operations. As required by their Federal charters, they operate solely in the secondary market for residential mortgages for single- and multi-family properties. In addition to limiting the products these corporations can purchase, their charters also limit the size of the loans they can buy. Within these statutory boundaries, FNMA and FHLMC purchase mortgages from lenders, including mortgage bankers, resupplying them with funds to finance new transactions which enable borrowers to buy homes and provide credit supplies to build and rehabilitate rental properties. Since their inception, FNMA and FHLMC have consistently provided mortgage products and services that increase the availability and affordability of housing for low-and middle-income Americans. And they provide them at no cost to the taxpayer.

FNMA's and FHLMC's business operations transform mortgages from localized, illiquid instruments into highly-rated investments, attractive to all kinds of investors, both retail and institutional, including insurance companies, pension funds, and foreign investors. They accomplish this through the "securitization" process. This linkage between the capital markets and local mortgage lending markets enhances the flow of mortgage funds across geographic regions around the country. The national scope of their operations diversifies their credit risk, thereby protecting the U.S. government against losses under any implied contingent liability. Geographic diversification also allows FNMA and FHLMC to remain in all markets, in good times as well as bad, ensuring homebuyers ready access to available funds--no matter what the economic climate.

FNMA and FHLMC are national secondary market institutions dedicated to providing affordable housing for homeowners as well as renters. Enhancements they bring to the housing marketplace include:

- Strong credit ratings that ensure the lowest possible interest rates (as much as one-third to one-half percent lower than if these entities weren't in the market).

- Total dedication to housing that ensures continuity throughout credit cycles and, over the long-term, in the flow of credit to housing.

- Integrity and experience that further contribute to their standard-setting roles in the national mortgage market.

- Economies of scale that help ensure the lowest possible costs, and the benefits of creative new programs, which are passed along in the form of affordable and decent housing.

Both FHLMC and FNMA have a clear Congressional mandate to provide mortgage credit for affordable housing. The Financial Institutions Reform, Recovery and Enhancement Act of 1989 (FIRREA) enhanced FHLMC and FNMA's mission by incorporating in the Statement of Purpose section of their charters the following:

"to provide ongoing assistance to the secondary market for home mortgages (including mortgages securing housing for low-and moderate-income families involving a reasonable economic return to the corporation) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for home mortgage financing."

FHLMC and FNMA have been active in targeting programs to low-income first-time homebuyers as well as renters. FNMA's Office of Low- and Moderate Income Housing works with lending institutions, state and local governments and non-profit organizations to develop and implement initiatives directed exclusively at low-income home buyers and renters. Over the past two years, FNMA has funneled over $4 billion into low-income housing supporting over 80,000 low income households.

MBA and FNMA have recently embarked on a joint venture to establish a model project for financing the construction of up to 4,000 low-cost rental units in six cities around the country.

Similarly, to further demonstrate that affordable housing is central to FHLMC's mission, they have just recently created an affordable housing initiatives department to develop and execute low- and moderate-housing finance transactions through increased corporate involvement with state and local finance agencies and non-profit organizations.

Mr. Chairman and Members of the Subcommittee, the stark reality of our ongoing budget deficits have put tremendous pressure on the government's ability to dedicate adequate resources to house deserving American citizens. FHLMC and FNMA have stepped in where the government has left off. Both corporations have increased their commitment to affordable housing in recent years and have done so in a responsible and prudent manner that has not put the taxpayers at undue risk.

CONTROLLING RISK

In the wake of the savings and loan debacle and amid growing concerns over the government's contingent liabilities with regard to Government Sponsored Enterprises (GSEs), it is understandable that Congress and the Administration feel the need to closely examine all GSEs and other government credit programs. No one will argue that GSEs should not be adequately capitalized. The question becomes, what is adequate. Determination of an adequate capital level requires that risk must be carefully and responsibly assessed. For FHLMC and FNMA it is essential to examine interest rate risk and credit risk.

Interest Rate Risk

Interest rate risk becomes a problem when the value of assets reacts differently than the value of liabilities, due to interest rate fluctuations. During the late 1970s and early 1980s, hundreds of portfolio lenders, particularly thrift institutions, failed as a result of unprecedented interest rate swings and imprudently managed interest rate risks. FNMA and FHLMC, on the other hand, are particularly adept in minimizing this risk, which helps assure their stability.

FNMA employs two strategies to minimize interest rate risk. First, it repackages home mortgages into MBSs that are sold to investors. FNMA earns guarantee fees for creating, guaranteeing, and providing service to investors. This provides to FNMA a fee-based income stream for the duration of the underlying security. The only negative sensitivity to interest rate movements that exists for FNMA is that if interest rates drop and the underlying mortgages refinance, then the fee income ends. Second, even with its portfolio holdings, FNMA avoids interest rate risks by maintaining a close duration match between assets and liabilities. FNMA is able to fund mortgage portfolio purchases through borrowing in the "agency" debt market, and has access to funds priced close to the Treasury yield curve across a range of maturities. It also holds a high proportion of its portfolio mortgages in the form of adjustable rate mortgages, which further reduces its exposure to interest rate risk.

FHLMC avoids interest rate risk by utilizing a mortgage pass-through security, which "passes through" principal and interest payments to investors as they are received from mortgage servicers. Investors thus bear all interest rate risk. Regardless of what rates do, FHLMC's fee income stream is locked in for the life of the underlying mortgage loans. FHLMC finances 95 percent of its mortgage purchases in this way, with the remainder representing new products awaiting securitization. Additionally, by selling securities as soon as mortgages are purchased--often the same day--FHLMC is largely insulated from even short-term interest rate movements.

Credit Risk

Credit risk is the risk that loans will go into default, and will result in the foreclosure of the underlying property. A significant factor in controlling credit risk is the "monoline" nature of FNMA's and FHLMC's business. Their government charters allow them to engage in only one line of business--the financing of high quality residential real estate loans--a business they perform very well. Their investment in mortgages on owner-occupied single family homes, with low loan-to-value (LTV) ratios, are considered to be among the highest quality financial assets available. The marketplace puts a premium on high quality whole loans and MBSs, and this premium is evidenced by the low amount of risk-based capital banks and thrifts are required to hold relative to these assets.

To manage credit risk further, both FNMA and FHLMC have created several layers of protection to ensure that the Federal government is highly insulated against any costs relating to their operations.

The first, and most important, layer of protection is the borrower. Homeowners are obligated to pay their mortgages, and do so in the vast majority of cases. However, if a homeowner encounters financial problems due to unemployment, sickness, or other debts, he or she is most likely to sell their house, rather than default, so that they can keep the equity in the property, which is often their single greatest asset.

A second layer is the underwriting, quality control, and servicing criteria set forth by FNMA and FHLMC. Their low default rates are directly attributable to high industry standards.

A third layer is the quality of the lenders with whom they do business. If a lender fails to follow carefully FNMA's or FHLMC's standard criteria for originating loans, that lender is contractually bound, under recourse arrangements, to buy back the loans in question.

A fourth layer of protection involves credit enhancements. While the best credit enhancement is a high percentage of borrower equity in a home, this isn't always possible. To assist borrowers lacking sufficient cash for high downpayments to be able to purchase homes, FNMA and FHLMC accept other credit enhancements, such as private mortgage insurance, collateral, and recourse.

A fifth layer of protection is the geographic diversification of the loans they purchase. Because FNMA and FHLMC buy loans in every state, regional downturns in the economy have less effect on their operations. Geographic diversity provides a buffer against regional downturns and significantly reduces the likelihood that these entities will have to draw on their capital.

The capital and reserves of these agencies, discussed below, are quite significant and serve as a further layer of protection.

CAPITAL ADEQUACY

Simply stated, capital is the difference between assets and liabilities. Based on the risks they assume, FNMA and FHLMC have more than adequate capital. Since 1985, FNMA has more than halved its leverage and increased its capital to $4 billion. Further, by the end of 1991 FNMA expects to have $6 billion in reserves. In 1989, FNMA had record earnings of $807 million, and put $704 million, or 87 percent, back into the business. Its capital exceeds the regulatory level established by the Department of Housing and Urban Development (HUD), currently a maximum ratio of debt-to-capital of 20-to-1.

In 1989, FHLMC had record earnings of $437 million--a 15 percent increase over 1988. It traditionally puts about 75 percent of its earnings back into its business, which would represent approximately $325 million for 1989. FHLMC also has cash reserves of about $500 million, with an additional $2.0 billion in equity capital on hand.

FHLMC has also doubled its capital since 1986. Currently it holds $2.4 billion in primary capital, $1.9 billion of which represents equity capital. In 1989, FHLMC had net earnings of $437 million. FHLMC's 4.32-to-1 debt-to-capital ratio far exceeds the 15-to-1 standard imposed by HUD.

There have been various suggestions that FNMA and FHLMC should be subject to more rigid capital standards than the ones currently enforced by HUD and currently implemented internally by the secondary mortgage market agencies. The Office of Management and Budget is suggesting legislative language that would require these agencies to maintain capital sufficient to receive a AAA rating by two private rating agencies, absent any implicit government guarantees. Other suggestions include subjecting Fannie Mae and Freddie Mac to risk-based capital standards similar to those imposed on banks and thrifts. While we support, in principle, the need for adequate capital support for GSEs, MBA believes both suggested measures are excessive and inappropriate given the specific characteristics and public mission of these agencies. Moreover, we would like to state for the record that analogies to the thrift crisis have been the cause of the current debate concerning agency capital adequacy. We believe such analogies are unfounded, designed to be inflammatory and tend to obfuscate the real issue.

The Price Waterhouse study commissioned by FHLMC and a Wolfenson study commissioned by FNMA indicate that the current level of capital held by FNMA and FHLMC is sufficient and consistent with prudent business strategies to fulfill their housing mission and Congressional charter. While the housing GSEs do involve some risk to the government, a clear understanding of the types and levels of risk and the ongoing strategies implemented for controlling them reveals that current capital is sufficient in light of the risks taken.

Just as impressive as the depth of their capital bases is the breadth of their MBS and equity ownership. Nontraditional investors such as pension funds and foreign institutions own sizable amounts of FNMA and FHLMC securities, even though the latter group has traditionally been less well-informed, or less enthusiastic, about the U.S. mortgage marketplace than their American counterparts. As for pension funds, which are subject to stringent investment standards, their holdings are also on the rise--a tribute to the confidence they place in these agencies.

There is some suggestion that perhaps FNMA and FHLMC should be subject to rigid capital standards, similar to those imposed on banks and thrifts. It would be inappropriate to impose a blanket standard on these agencies, because they are not part of an industry with a large number of institutions spread across the country, such as the 13,000 banks and 3,000 thrifts, whose financial conditions can be compared on a uniform basis. Rather, they are government charted enterprises whose operations are legislatively circumscribed and are subject to both legislative and regulatory review. If FNMA and FHLMC were required to raise an arbitrary amount of capital to help protect the government against extremely remote economic circumstances, this would raise their costs and result in higher interest rates for home borrowers. Higher rates would also negatively impact upon the RTC's ongoing efforts in disposing of failed thrifts and their assets.

Another contrivance that would raise interest rates, would be the imposition of user fees on FNMA and FHLMC, as proposed in the Administration's FY 1991 budget. This proposal, which is nothing more than a tax on homeownership, is especially curious in light of a statement in the budget which characterizes the government's contingent liability resulting from their activities as "remote".

MBA believes that these agencies are not "hidden Pacmen" waiting to spring forward and gobble up Federal Government revenues. On the contrary, they are fiscally sound corporations that provide affordable housing, make money for their stockholders, and pay taxes.

An important consideration in monitoring capital levels is determining the likelihood that capital may erode. FNMA and FHLMC currently employ stress tests to determine the effects of extreme economic conditions on their ability to remain solvent. In principal, we believe that a reasonable stress test is helpful in monitoring capital adequacy. However, we do not believe economic "stress tests" should be used as an exclusive measure of capital. Levels of management protection, credit enhancements, underwriting standards, types of loans and LTV of loans in portfolio and backing securities, etc. all play significant roles in default rates and, thus, losses.

Both FNMA and FHLMC currently employ economic stress tests. FNMA applies a combination of 8.5% lifetime default rates based on defaults experienced in Texas in 1981-82 and an assumption that interest rates increase 600 basis points and remain at that level for four years. Using these realistic conditions, FNMA not only remains solvent, but does not suffer any capital impairment. HUD's study further demonstrates the financial health of FNMA. According to its rigorous baseline assumptions, FNMA could withstand nine years of interest rates as high as 22%. Few financial institutions are capable of withstanding this exposure.

FHLMC also applies a stress test based on conditions during the Great Depression. Using this model, FHLMC and Price Waterhouse have indicated that it would be able to withstand ten years.

Clearly, economic conditions as severe as the Great Depression or as lasting as a ten-year, 22% interest rate scenerio have no realistic chance of occurring with today's monetary controls. They represent excessive measures of capital strength.

FEDERAL OVERSIGHT

Theoretically, the better the oversight, the less capital is needed. FNMA and FHLMC have plenty of oversight--in fact, they live in a fishbowl. They are scrutinized by Congress, regulated by HUD, overseen by the Treasury Department, audited by the General Accounting Office (GAO) and public accountants, examined by Wall Street investment analysts, and are accountable to common stockholders.

Several statutes and regulations provide for continuous monitoring of FNMA and FHLMC by the Treasury Department, HUD, and the GAO. Treasury has the authority to approve the form of securities issued by these agencies, and its primary function has been to determine the timing as to when FNMA, and now FHLMC, should be in the marketplace with debt obligations, because of the impact their market presence could have with respect to issuances by other agency borrowers and the Treasury.

HUD, by virtue of the Charter Acts of FNMA and FHLMC, is empowered to exercise general regulatory oversight and rulemaking authority, to require appropriate reports, and to pre-approve new issuances of capital stock, dividends relating thereto, and convertible debt. In addition, HUD has the express authority to increase the minimum debt-to-capital ratios of these agencies. Further, HUD is scheduled to publish a proposed regulation on Fannie Mae and Freddie Mac sometime this fall.

In addition to HUD oversight, FIRREA mandates the GAO to conduct two studies of all GSEs, including FNMA and FHLMC, which will evaluate the types of risks they undertake and the appropriateness of applying risk-based capital standards to GSEs. These reports are to be submitted to Congress no later than May 1, 1990, and May 1, 1991, respectively. The GAO's first report is anticipated to be published shortly.

Two annual reports by the Treasury Department of GSEs, including FHLMC and FNMA, are also required under FIRREA. Treasury has already submitted the first report and the next report is due by May 15, 1991.

Some have suggested the need for an independent GSE regulator that would regulate and oversee the activities of all GSEs. MBA believes this proposal is without merit. HUD has the housing and secondary market expertise needed to regulate FNMA and FHLMC properly, and this expertise is not easily transferable to a generic GSE regulator. HUD Secretary Jack Kemp has formed a new Regulatory Review Board consisting of the Under Secretary, the Assistant Secretary for Housing--FHA Commissioner, the General Counsel, the Assistant Secretary for Community Planning and Development, and the President of GNMA, which will enable HUD to focus its attention better on these agencies. MBA believes this Board should be afforded the opportunity to prove itself a vigorous regulator before alternative mechanisms are considered.

REFORM PROPOSALS

On May 14, the Treasury and GAO testified before the House Ways and Means Subcommittee on General Oversight. The following day, May 15, the Senate Banking Committee held a similar hearing.

Treasury's testimony there and subsequent draft legislative proposals which have surfaced in the context of the Budget Summit negotiations have proffered four recommendations:

- A GSE should be adequately capitalized, meet high credit and operational standards and be subject to effective government supervision or Congress should terminate all government ties with the GSE;
- A private market mechanism should be used to evaluate GSE risk. Treasury recommended that GSEs be required annually to obtain a rating equivalent to "AAA" absent any implicit Government guarantee, from at least two of the nationally recognized credit rating agencies;
- GSEs should be regulated by the Treasury, rather than HUD in the case of FNMA and FHLMC; and
- The Administration should include in the President's budget the value of the government's guarantee to each GSE.

Under the proposals, GSEs that fail to meet the AAA rating would have to submit to Treasury a business plan outlining a strategy for reaching the rating within five years. Failure to meet the requirement within five years would cause the agencies to be subject to a risk premium and cause them to lose certain privileges, such as the exemption from SEC registration, exemption from state and local taxes, and eligibility for bank or thrift investments. Furthermore, limitations on growth or volume caps could also be imposed. To obtain a AAA rating, FNMA and FHLMC would have to increase their capital. FNMA and FHLMC have the following options to raise capital:

- Reduce dividends--This would decrease the attractiveness of the entities' stock to investors because earnings per share will be diluted. Moreover, a reduction in dividends would not have a dramatic impact on their capital positions.
- Issue additional stock--This option would be costly if they are forced to issue stock during adverse market conditions, which will result in a higher cost of equity capital.
- Increase fees--Higher guarantee and other fees charged the issuer or servicer would be passed on to homebuyers in the form of higher interest rates.
- Borrow less--Decreasing the amount of borrowing translates into less mortgage purchases, resulting in less credit for mortgage lending and more selective purchases.
- Cut Expenses--To decrease expenses, the entities will likely implement tighter underwriting standards to reduce defaults, thus making it tougher for homebuyers to obtain credit.

MBA is opposed to the AAA rating and, thus, higher capital requirements for FNMA and FHLMC, because it will serve to unnecessarily limit credit availability and raise interest rates for home buyers.

Rating Systems for Mortgage-Backed Securities.

An article entitled "The Role of the Rating Agencies: A Standard & Poor's Perspective",[1] which was reviewed by the S&P Mortgage Group, provides some significant insights into the rating process for mortgage backed securities. The authors state that "It is interesting to note the exclusive nature of the AAA category. Only twenty industrial corporations in the United States, for example, presently carry AAA ratings on their public debt." Also,it is important to note that only one domestic financial institution meets the AAA rating of Moody's Investors Services and of Standard and Poor's.

The following Tables illustrate the application of the rating system to mortgage backed security pools that are *privately issued*.

---

[1] O'Meara, James J., Vice President--Mortgage Finance, First Boston Corporation and Tibbals, David D., C.F.A., Vice President--Mortgage Finance, Salomon Brothers, Inc. (Formerly Vice Presidents of Standard & Poor's Mortgage Group), The Handbook of Mortgage Banking: A Guide to the Secondary Mortgage Market, Chapter 6, "The Role of the Rating Agencies: A Standard & Poor's Perspective", Dow Jones-Irwin, Homewood, Illinois, 1985.

Table 1

Minimum Loss Protection Levels for Prime Pools

Rating Category	Loss Coverage*	Foreclosure Frequency	Loss Severity
AAA	7%	15%	47%
AA	4	10	40
A	2.8	8	35

NOTE: All percentages are based on the initial aggregate loan balance.

* Loss coverage is the product of the foreclosure frequency and loss severity. Lower loss coverage levels are used for AA and A ratings because less severe economic conditions are assumed.

Table 2

Example of Loss Severity Calculation for Prime Loans (AAA rating assumptions)

Purchase price of home	$100,000	
Loan Balance (80% of purchase price)		$80,000
Market Value decline (37% of purchase price)*	(37,000)	
Market Value at foreclosure sale	(63,000)	$63,000
Market Loss		$17,000
Foreclosure costs (25% of loan balance)**		+20,000
Total		$37,000

Total loss divided by loan balance = severity of loss
$37,000/$80,000 = 47%

---

*Derived from estimated decline in property values during the 1930s (25% to 30%) adjusted to reflect fire sale price at foreclosure.

**Foreclosure costs include accrued interest (12%), brokerage fees (5%), legal fees (3%), taxes (3%), and other miscellaneous items including property maintenance expenses (2%). Mortgage loan is assumed to have an interest rate of 12%, and foreclosure period is expected to last 12 months.

For a AAA rating, the authors state that "these loss levels are extremely conservative and should be sufficient to cover losses during periods of severe economic distress, more severe than any period experienced during the post-World War II era."

Clearly, a AAA rating on mortgage-backed security issues is virtually a gold-plated assurance that only an economic recession of near-Depression depth will create a loss. Some will undoubtedly ask, what is wrong with the Federal Government insulating itself from any risk? The answer, simply put is that if the programs completely insulate themselves from risk, there will be little reason for their existence.

IMPACT OF THE REFORM PROPOSALS

There are many reasons to reject the OMB/Treasury proposals. They have the potential to destroy the secondary market. It is certain that they would raise mortgage rates. The low- and moderate-income home buyers who need the most help would be penalized. The proposals will significantly impact the ability of FHLMC and FNMA to carry out their public mission.

Increased Mortgage Interest Rates

The OMB/Treasury proposal could create a tightening of credit in the housing market by restricting FNMA and FHLMC's flow of affordable funds. They would have to set aside more capital to reach reserve or ratings requirements. As a result, interest rates would rise, thereby increasing the mortgage cost for home buyers. Potential home buyers would need to either come up with additional cash at settlement to buy down the interest rate or be able to qualify at the higher interest rate. Unfortunately, these options are not available to many Americans.

We know that there is a direct correlation between interest rates and affordability. For example, according to the results of a simulation of the sensitivity of housing starts and resales to changes in mortgage interest rates, a 50 basis point interest rate increase results in approximately 150,000 to 175,000 fewer total housing starts and existing home sales. While these are just numbers generated from a model, when they are put into perspective it becomes clear that every number represents a renter whose dream of owning a home will not become a reality.

Penalizes Housing Entities for Helping Where They're Most Needed

A ratings-driven and growth-constrained business will invest only in gold-plated product, which is not the public policy mission Congress conferred by charter. FNMA and FHLMC are unique in that they were chartered as private companies with public missions: to engage in public-private partnerships to finance housing for poorer families through community lending, purchase of mortgage revenue bonds, and equity investments using low-income housing tax credits. This broad service to American families which has worked well and has earned strong, continuing support from policy makers, housing advocates, and home buyers would be discontinued.

Abdication of Government Responsibility

The proposal makes utility and perhaps even the survival of the housing GSEs dependent solely on the decisions of a private rating agency without any published standards. In effect the government would delegate to private parties the power to control the program responsibilities of the housing GSE's. Private sector goals may not be congruent with the congressional mandate to increase the availability and affordability of conventional mortgage funds for home buyers. Ultimately, the big loser would be low- to moderate-income families.

Distinctions Between Financial Institutions and Secondary Mortgage Market Entities.

There are significant differences between depository institutions and the secondary market entities that make it inappropriate to apply a bank and thrift capital requirement to the secondary market agencies.

- By law, FNMA and FHLMC cannot take deposits, cannot make or purchase loans on office buildings and other commercial real estate. The agencies are limited to a single line of business: purchasing and securitizing high quality residential loans. This in turn has made FNMA and FHLMC experts in their business. A significant reason for problems that arose within the thrift industry was permitting institutions to become active in new lines of businesses without demonstrating a knowledge of the business and without the appropriate levels of supervision. This is not the case with FNMA and FHLMC.

- FNMA and FHLMC are also highly visible companies that are subject to legislative and regulatory scrutiny. The fact that FNMA and FHLMC must report to Congress, are regulated by HUD, audited by GAO and other independent companies, and also subject to stockholder and investor scrutiny decreases the possibility that the financial stability of the agencies could deteriorate, without notice, to such a degree that federal assistance would be necessary.

- Furthermore, unlike many regional depository institutions FNMA and FHLMC purchase loans nationwide, which allows them to disperse risk and avoid incurring losses due to regional economic downturns. By spreading risk across every state, FNMA and FHLMC have reduced by one half its chance that it will be so severely impacted by a regional recession that it will have to draw on its capital.

MBA appreciates the opportunity to submit a written statement for the hearing record and will be pleased to provide any additional information, if needed.